BANKING AND INSURANCE

MBA (OU) IV-Semester (Finance) (Elective-IV)

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R16 **MODEL PAPER 1**

FACULTY OF MANAGEMENT

MBA (CBCS) IV-Semester Examinations

Model Paper-I

BANKING AND INSURANCE

Time: 3 Hours Max. Marks: 80

Note : Answer all the questions from **Part-A** and **Part-B**.

Each question carries **4** marks in **Part-A** and **12** marks in **Part-B**.

PART-A (5 × 4 = 20 Marks)

(Short Answer Type)

Solutions

1. CAMELS Ratings. (Unit-I / Page No. 1.42 / Q1)
2. Causes for Increasing NPA's. (Unit-II / Page No. 2.32 / Q1)
3. Advantages of Net Banking. (Unit-III / Page No. 3.41 / Q5)
4. Write about insurable interest and subrogation. (Unit-IV / Page No. 4.22 / Q2)
5. Remuneration to Insurance Broker. (Unit-V / Page No. 5.26 / Q3)

PART-B (5 × 12 = 60 Marks)

(Essay Answer Type)

6. (a) Describe the structure of Indian Banking System. (Unit-I / Page No. 1.2 / Q1)

OR

(b) Discuss the recommendations of Narasimhan Committee for the banking reforms in India. (Unit-I / Page No. 1.11 / Q9)

7. (a) Describe briefly about the credit process and it's constituents. (Unit-II / Page No. 2.8 / Q9)

OR

(b) Explain the basic model of loan pricing. Also write about cost-benefit loan pricing. (Unit-II / Page No. 2.23 / Q21)

8. (a) What do you mean by banking innovations? Explain the new concept of innovations in banks. (Unit-III / Page No. 3.11 / Q7)

OR

(b) What do you mean by term bancassurance? Write about its role in banks, insurance companies and customers. (Unit-III / Page No. 3.32 / Q24)

9. (a) Write a note on principles of insurance. (Unit-IV / Page No. 4.12 / Q15)

OR

(b) Define Insurance. Explain the nature and characteristics of insurance. (Unit-IV / Page No. 4.2 / Q1)

10. (a) Explain the different types of life insurance contracts. (Unit-V / Page No. 5.4 / Q3)

OR

(b) Explain various types of life insurance contracts. Write a short notes on tax treatment of life insurance. (Unit-V / Page No. 5.9 / Q9)

R16

MODEL PAPER 2

FACULTY OF MANAGEMENT

MBA (CBCS) IV-Semester Examinations

Model Paper-II

BANKING AND INSURANCE

Time: 3 Hours Max. Marks: 80

Note : Answer all the questions from **Part-A** and **Part-B**.

Each question carries **4** marks in **Part-A** and **12** marks in **Part-B**.

PART-A (5 × 4 = 20 Marks)

(Short Answer Type)

Solutions

1. CRR. (Unit-II / Page No. 2.32 / Q2)
2. Financial Inclusion. (Unit-I / Page No. 1.42 / Q2)
3. Advantages of Reinsurance. (Unit-IV / Page No. 4.23 / Q3)
4. Whole Life Insurance. (Unit-V / Page No. 5.26 / Q1)
5. Three Pillars of Basel II. (Unit-III / Page No. 3.43 / Q11)

PART-B (5 × 12 = 60 Marks)

(Essay Answer Type)

6. (a) Elucidate the role of banks as financial intermediaries. (Unit-I / Page No. 1.15 / Q12)

   OR

   (b) Elaborate the role of commercial banks in economic development of developing countries. (Unit-I / Page No. 1.17 / Q14)

7. (a) Define the term loan. Explain briefly about different types of loans provided by banks and their features. (Unit-II / Page No. 2.13 / Q12)

   OR

   (b) Discuss the causes and implications of NPA in banks. Suggest measures for recovery of NPA's. (Unit-II / Page No. 2.30 / Q29)

8. (a) Write a detailed note on banking innovations we have witnessed in the last decade. Also explain IT products of banks. (Unit-III / Page No. 3.15 / Q9)

   OR

   (b) Define Gateways. Write in detail about RTGs and its impact on the financial sector. (Unit-III / Page No. 3.37 / Q30)

9. (a) Explain the concept of insurance and state the functions of insurers. (Unit-IV / Page No. 4.15 / Q18)

   OR

   (b) Discuss the future prospects of insurance companies. (Unit-IV / Page No. 4.19 / Q23)

10. (a) What is distribution channel? Explain the role and responsibilities of agents and brokers in insurance. (Unit-V / Page No. 5.13 / Q14)

    OR

    (b) Explain different types of general insurance policies. (Unit-V / Page No. 5.16 / Q17)

R16

MODEL PAPER 3

FACULTY OF MANAGEMENT

MBA (CBCS) IV-Semester Examinations

Model Paper-III

BANKING AND INSURANCE

Time: 3 Hours Max. Marks: 80

Note : Answer all the questions from **Part-A** and **Part-B**.

Each question carries **4** marks in **Part-A** and **12** marks in **Part-B**.

PART-A (5 × 4 = 20 Marks)

(Short Answer Type)

Solutions

1. Non Life Insurance. (Unit-V / Page No. 5.26 / Q2)
2. Types of Insurance. (Unit-IV / Page No. 4.22 / Q1)
3. Bancassurance. (Unit-III / Page No. 3.43 / Q12)
4. Different types of Loans. (Unit-II / Page No. 2.33 / Q6)
5. Short Comings of Indian Banking System. (Unit-I / Page No. 1.42 / Q4)

PART-B (5 × 12 = 60 Marks)

(Essay Answer Type)

6. (a) Explain briefly about different types of accounts prepared in banks. (Unit-I / Page No. 1.25 / Q24)

OR

(b) Explain the key performance indicators of banks. (Unit-I / Page No. 1.37 / Q34)

7. (a) Support the concept of Customer Profitability Analysis (CPA) with an example. (Unit-II / Page No. 2.24 / Q23)

OR

(b) What do you mean by (NPA's) Non Performance Assets? Briefly explain the features and classification of NPA's and the provisions that should be maintained for each category. (Unit-II / Page No. 2.25 / Q24)

8. (a) Write about the nature and scope of retail banking products. Write a short note on remittance products. (Unit-III / Page No. 3.19 / Q12)

OR

(b) Explain briefly net banking/online banking. What are the advantages and disadvantages of net banking? (Unit-III / Page No. 3.27 / Q22)

9. (a) Write a brief note on IRDA's regulatory. (Unit-IV / Page No. 4.21 / Q25)

OR

(b) Explain in detail the different types of insurers. (Unit-IV / Page No. 4.16 / Q19)

10. (a) What is credit insurance? Explain the three corporations established by government of India to provide credit insurance. (Unit-V / Page No. 5.22 / Q23)

OR

(b) Discuss in detail about crop insurance. (Unit-V / Page No. 5.25 / Q28)

Code No. 4571

FACULTY OF MANAGEMENT

MBA IV-Semester (CBCS) Examination

May/June- 2018

BANKING AND INSURANCE

Paper – MB – 405 – I (Finance)

(Elective – IV – Finance)

Time: 3 Hours | Max. Marks: 80

Note: *Answer* ***All*** *the Questions from Part-A and Part-B*

Each question carries **4** *marks in* ***Part-A*** *and* **12** *marks in* ***Part-B***

PART-A (5 × 4 = 20 Marks)

(Short Answer Type)

1. State the functions of Commercial Banks.
2. Distinguish between fixed and floating rates.
3. What is meant by Core Banking solution?
4. What are the principles of Insurance?
5. State the types of General Insurance Business.

PART-B (5 × 12 = 60 Marks)

(Essay Answer Type)

6. (a) Describe the structure and significance of Indian Banking System.

OR

(b) Explain the functions of Reserve Bank of India.

7. (a) Discuss the Procedure for assessment of credit worthiness of a prospective borrower.

OR

(b) What is NPAs and state the causes and its implications in Banking Operations.

8. (a) As the interest rates are expected to change, ABC Bank wants to charge floating rate of interest to its borrower. The present prime rate is 8% p.a. The bank wants to charge a premium of 350 basis points over the prime rate for this borrower. You are required to find the floating rate for the borrower as per prime plus and prime time-rate methods and which of the two methods would be beneficial to the bank. Further, if the prime rate increase to 9% and/or decreases to 7.5% what would be the floating rate for the borrow.

OR

(b) A customer wants to borrow ₹ 50 crs from XYZ Bank. The bank studied the risk associated with the borrow and found that the probability of repaying the principal and interest is 94% as per schedule. In case of difficulty the bank loan recover 81% of the principle and interest due. The minimum required rate for the bank is 14%. The cost of funds for the banks is 12% and the associated service cost is 0.25%. What rate should the bank quote to the borrower?

9. (a) Discuss the significance of Insurance Business in Indian Economy.

OR

(b) Explain the salient features of different Life Insurance products.

10. (a) Describe the advantages of general Insurance Business activities.

OR

(b) Discuss the role of marketing intermediaries in insurance and business operations.

SOLUTIONS TO MAY/JUNE- 2018, QP

PART-A (5 × 4 = 20 Marks)

(Short Answer Type)

Q1. State the functions of Commercial Banks.

Answer :

The functions of commercial banks are basically divided into the following two types,

I. Primary functions

II. Secondary functions.

I. Primary Functions

The primary banking functions of commercial banks are,

1. Acceptance of deposits from the public

2. Creating credit.

1. Acceptance of Deposits from the Public

The primary/basic function of the commercial banks is to accept the savings as deposits from the public and to mobilise such savings of the household section.

2. Creating Credit

The second important primary function of the commercial banks is the creation of credit by providing loans and advances.

II. Secondary Functions

(i) The commercial banks acts as an agent of its client and collect or pay interest, rent, dividends and insurance etc.

(ii) The commercial banks may also buy and sell the securities of its clients.

(iii) It protects the valuables like confidential documents of its clients by providing bank lockers or safe deposits vaults to its customers.

Q2. Distinguish between fixed and floating rates.

Answer :

Following are the differences between fixed and floating rates,

	Fixed Exchange Rate		Floating Exchange Rate
1	Fixed exchange rate implies the rate which in decided by the government.	1.	Floating exchange rate implies the rate which fluctuates as per market forces.
2.	It is determined by government or central bank so referred as "administratively determined".	2.	It is determined by demand and supply forces so referred as "market forces determined".
3.	Currency prices are devalued and revalued.	3.	Currency prices are depreciated and appreciated.
4.	Speculation of fixed exchange rate rarely happens.	4.	Speculation of floating exchange rate is very common.
5.	In this permanently fixed rate and adjustable rate are distinguished.	5.	In this clean and managed float are distinguished.

Q3. What is meant by Core Banking solution?

Answer :

For answer refer Unit-III, Page No. 3.40, Q.No. 2, Topic: Core Banking Solution.

Q4. What are the principles of Insurance?

Answer :

For answer refer Unit-IV, Page No. 4.12, Q.No. 15.

Q5. State the types of General Insurance Business.

Answer :

For answer refer Unit-V, Page No. 5.16, Q.No. 17, Topic: Types of Non-life Insurance or General Insurance (First Five Points Only).

PART-B (5 × 12 = 60 Marks)

(Essay Answer Type)

Q6. (a) Describe the structure and significance of Indian Banking System.

Answer :

Structure of Indian Banking System

For answer refer Unit-I, Page No. 1.2, Q.No. 1.

Significance of Indian Banking System

The following points highlights the importance of Indian banking system.

1. Indian banking system helps in enhancing the relation between unorganized and organized sectors.
2. It helps in generating money.
3. It helps in providing long-term loans.
4. It helps in controlling balance of trade.
5. It facilitate 'cheque payment system' which is the secure method for making policy.
6. It helps small scale firms and agricultural units.
7. It helps in implementing effective monetary policy.
8. It helps in capital formation.
9. It helps in providing extensive infrastructural.
10. It encourages entrepreneurs.

OR

(b) Explain the functions of Reserve Bank of India.

Answer :

For answer refer Unit-I, Page No. 1.20, Q.No. 17.

Q7. (a) Discuss the Procedure for assessment of credit worthiness of a prospective borrower.

Answer :

For answer refer Unit-II, Page No. 2.4, Q.No. 4.

OR

(b) What is NPAs and state the causes and its implications in Banking Operations.

Answer :

For answer refer Unit-II, Page No. 2.30, Q.No. 29, Topics: NPA, Causes of NPA's , Implications of NPA's.

Q8. (a) As the interest rates are expected to change, ABC Bank wants to charge floating rate of interest to its borrower. The present prime rate is 8% p.a. The bank wants to charge a premium of 350 basis points over the prime rate for this borrower. You are required to find the floating rate for the borrower as per prime plus and prime time-rate methods and which of the two methods would be beneficial to the bank. Further, if the prime rate increase to 9% and/or decreases to 7.5% what would be the floating rate for the borrow.

Answer :

Base Case

The prime rate is at 8 percent

Desired premium is 350 bps by following additive method, the loan price would be 8 + 3.5 = 11.5 percent.

When multiplicative method is used, the adjustment factor would be 11.5/8 = 1.4375

∴ By the multiplicative method, the loan price would be similar to the additive method i.e., 8 × 1.4375 = 11.5 percent

Case 1

The prime rate increase to 9%

The loan price by the prime plus method would be 9 + 3.5 = 12.5%

The loan price by the prime times method would be 9 × 1.4375 = 12.9%

Case 2

The prime rate decreases to 7.5%

The loan price by the prime plus method would be 7.5 + 3.5 = 11%

The loan price by the prime times method would be 7.5 × 1.4375 = 10.78%

Conclusion

The loan price will be same for given prime rate under both the methods. When there is increase in prime rate, the prime times method will yield higher return for the bank. When there is decrease in price rate, prime plus method is more beneficial to the bank.

OR

(b) A customer wants to borrow ₹ 50 crs from XYZ Bank. The bank studied the risk associated with the borrow and found that the probability of repaying the principal and interest is 94% as per schedule. In case of difficulty the bank loan recover 81% of the principle and interest due. The minimum required rate for the bank is 14%. The cost of funds for the banks is 12% and the associated service cost is 0.25%. What are should the bank quote to the borrower?

Answer :

[**Note:** Some information is missing in this problem In order to solve the problem, we are assuming principal amount as 5,000 and profit margin as 3 percent].

Given that,

Probability of recovery = 94%

Probability of default = 6%

Principal amount = 5000

Contracted rate of interest = 14%

Recovery rate in the event of default = 81%

Cost of funds = 12%

Service cost = 0.25%

Bank plans to quote the rate of 14 percent but it is not possible as there is default risk attached to the borrower. Expected rate can be computed as,

$$E(r) = P(R) + P(D) \times \left\{\left[\frac{R(P+P_r)}{P}\right] - 1\right\}$$

$$= (0.94 \times 14\,\%) + 0.06 \times \left\{\left[\frac{0.81 \times 5000 + (5000 \times 0.14)}{5000}\right] - 1\right\}$$

$$= 13.2 + 0.06 \times \left\{\left[\frac{0.81 \times 5700}{5000}\right] - 1\right\}$$

$$= 13.2 + 0.06 \times (-\,0.0766)$$

$$= 13.2 - 0.0045 = 13.195$$

Bank will gain return of 13.19 percent from loan contracted to generate 14 percent. Difference between contracted rate and expected rate is 0.70 considered as risk premium.

Thus, bank can price the loan to borrower at a minimum of 12(cost of funds) + 0.25 (servicing costs) + 0.70 (risk premium) + 3 (desired profit) i.e., 15.95 percent.

Q9. (a) Discuss the significance of Insurance Business in Indian Economy.

Answer :

For answer refer Unit-IV, Page No. 4.3, Q.No. 3.

OR

(b) Explain the salient features of different Life Insurance products.

Answer :

For answer refer Unit-V, Page No. 5.2, Q.No. 1, Topic: Aspects/Features of Life Insurance.

Q10. (a) Describe the advantages of general Insurance Business activities.

Answer :

Following are the advantages of general insurance,

1. General insurance is useful in securing business from natural calanities, short circuit or any other unexpected danger.
2. General insurance policy relating to health and medical facilities will manage the cost of medical treatment.

3. Costs which are related to pets are also taken care by pet insurance policy under general insurance.
4. Costs which are incurred due to accident can be managed through accident insurance policies under general insurance.
5. Home insurance policies of general insurance helps to protect home from several dangers such as fires, floods, etc.
6. Unemployment insurance is useful for insured if she or he losses the job.
7. Travel insurance plans under general insurance helps to deal with expenses emerging from any unfortunate and serious situations while traveling aboard.
8. General insurance also provides motor vehicle insurance plans which are helpful in bearing expenses incurred for repairing a vehicle damaged in an accident.

OR

(b) Discuss the role of marketing intermediaries in insurance and business operations.

Answer :

For answer refer Unit-V, Page No. 5.13, Q.No. 14, Topic: Role of Agents and Brokers in Insurance Contracts, Authority of Agents and Brokers.

Code No. 1071

FACULTY OF MANAGEMENT

MBA (CBCS) IV-Semester Examination

May/June - 2019

BANKING AND INSURANCE

Paper – MB – 405 – I (F)

(Elective – IV – Finance)

Time: 3 Hours | Max. Marks: 80

*Note: Answer **All** the Questions from Part-A and Part-B*
*Each question carries **4** marks in **Part-A** and **12** marks in **Part-B***

PART-A (5 × 4 = 20 Marks)

[Short Answer Type]

1. State the structure of Indian Banking System.
2. What is meant by priority sector lending?
3. State the recent banking innovations.
4. What is the nature of insurance business?
5. State the types of General Insurance.

PART-B (5 × 12 = 60 Marks)

[Essay Answer Type]

6. (a) Describe the evolution of Banking System in India.

OR

(b) Discuss the vital aspects of BASEL norms I, II and III.

7. (a) Explain the process of credit granting and its management.

OR

(b) Describe the issues relating to customer profitability analysis.

8. (a) A borrower of a bank is sanctioned ₹ 10 crores credit limit, but utilized only ₹ 8 crores on an average at contracted rate of 20%. The borrower will have to pay a commitment fee of 0.5% on the unused portion of the credit limit. The bank insists that the borrower maintains a margin of 20% for the utilized portion of the credit limit and 5% for the unutilized portion. The central bank imposes a reserve requirements of 10% of the deposits. You are required to find:

(i) The estimated loan revenue

(ii) The estimated bank funds outlay for the borrower and

(iii) The estimated before tax yield to the bank from this loan.

OR

(b) The current prime lending rate is 9% and the future interest rates are expected to be volatile and have Crax Bank wants to change floating rate on loans to its borrowers. For a particular borrower the bank decided to charge 350 basis points premium over the prime rate to cover for the risk. You are required to:

(i) Find the prime plus and prime time rates chargeable to the borrower

(ii) If the prime rate increases by 1.5% and decreases by 1.5% how would the principles and prime time rates change to the borrower.

(iii) In case of increasing or decreasing interest rate which of the two methods are beneficial to the bank.

9. (a) Describe the History and Development of Insurance Sector in India.

OR

(b) Explain the functioning of IRDA.

10. (a) Distinguish between life insurance and general business operations in detail.

OR

(b) Explain the settlement of claims mechanism in life insurance business.

SOLUTIONS TO MAY/JUNE-2019, QP

PART-A (5 × 4 = 20 Marks)

[Short Answer Type]

Q1. State the structure of Indian Banking System.

Answer :

For answer refer Unit-I, Page No. 1.2, Q.No. 1 (First Paragraph and Figure).

Q2. What is meant by priority sector lending?

Answer :

For answer refer Unit-II, Page No. 2.30, Q.No. 30, Topic: Priority Sector Lending.

Q3. State the recent banking innovations.

Answer :

Banking innovation generally refers to bringing new concepts and technologies in the sector of banking in order to enhance technological advancement and to improve the performance of the banking system. Some of the innovative products and services offered by banks include,

(i) Cash Less Economy

The initiative of cashless economy by banking sector resulted in partnership with startup companies to acquire e-wallets and make them accessible to customers. For example. Yes Bank in partnership with free charge and chillr, a multi-bank mobile payment app provide online banking to its customers.

(ii) High Tech Banking Products and Services

The various high-tech banking products and services include,

(a) Internet banking

(b) E-Cheques

(c) Tele-banking.

(iii) Products and Services for Non-Residents

The products and services that are offered for non-residents include, shemes without repatriation, scheme with repatriation, Pay Quick.com, telegraphic transfer and portfolio services.

(iv) Other Important Services

The various quality services that are offered by banks to different classes of customers include, branch banking, Corp power cheq, Corp mediclaim, Corp E-rail, Corp bill pay, Corp mobile recharge, Corp anytime premium, Corp junior, mutual funds and depository services.

(v) Innovation Labs and Digital Villages

Banks are launching innovation labs to push startups. Banks are establishing Digital villages in the rural areas to encourage technology access in those areas.

Q4. What is the nature of insurance business?

Answer :

For answer refer Unit-IV, Page No. 4.2, Q.No. 1, Topic: Nature of Insurance.

Q5. State the types of General Insurance.

Answer :

For answer refer Unit-V, Page No. 5.16, Q.No. 17, Topic: Types of Non-Life Insurance or General Insurance (1 to 7 Points Only).

PART-B (5 × 12 = 60 Marks)

[Essay Answer Type]

Q6. (a) Describe the evolution of Banking System in India.

Answer :

For answer refer Unit-I, Page No. 1.8, Q.No. 6.

OR

(b) Discuss the vital aspects of BASEL norms I, II and III.

Answer :

The following are the vital aspects of Basel norms I, II and III.

Basel Norm I

The important aspects/elements of Basel norm I are,

1. Basel norm/Accord I states that the central banks of GIO member countries should maintain a minimum capital i.e equal to atleast 8% of the assets associated with different risks.
2. Banks should maintain atleast half of the capital with a composition of shareholder's equity and retained earnings.
3. The assets are categorized into four groups 10%, 20%, 50% and 100% which represents the risk rate associated with the assets.
4. Basel norm I ensures the minimum required capital levels in an international banking system.

Basel Norm II

The important aspects or pillars or elements of Basel norm II are,

1. The first pillar aims to calculate capital by considering the credit risk, market risk and operational risks faced by the banks.
2. The capital has been divided into 2 tiers, in tier I, 50% of capital is allocated for equity and known reserves, whereas in tier II, remaining 50% is allocated for general provisions and unknown reserves.
3. The second pillar aims to control the risk through supervisory review process.
4. For supervisory review, BCBs has recommended four principles such as,
   (i) Banks should have a process to assess their overall capital adequacy in relation to their risk profile.
   (ii) Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies.
   (iii) Supervisors should accept banks with the minimum regulatory capital ratios.
   (iv) Supervisors should intervene at an early stage to prevent capital reduction to its minimum levels.
5. The third pillar supports to fulfill the objectives of first and second pillars.
6. Third pillar orders banks to provide the details in every 6 months regarding the capital adequacy ratios and any risk related factors or changes.

Basel Norm III

The important aspects/elements of Basel norm III are,

1. Basel norm III is a global regulatory framework for banks and banking systems of BCBs.
2. The essential capital requirements should be atleast 9% of Risk-Weighted Assets (RWAs).
3. The capital should be maintained in the form of common equity as 2.5% of RWAs.
4. Banks are supposed to determine an additional Credit Value Adjustments (CVA) risk capital charge apart from counter partly capital charge for default risk under the risk in case of OTC derivatives.
5. Basel III introduced the Counter-Cyclical Butter (CCB) which range between 0 – 2.5% in order to protect the banking system from excess credit growth.

Q7. (a) Explain the process of credit granting and its management.

Answer :

Process of Credit Granting

For answer refer Unit-II, Page No. 2.8, Q.No. 9, Topic: Credit Process, Steps of Credit Process.

Credit Management

For answer refer Unit-II, Page No. 2.11, Q.No. 10, Topic: Credit Management.

OR

(b) Describe the issues relating to customer profitability analysis.

Answer :

The various issues relating to customer profitability analysis in any business are as follows,

1. Customer profitability analysis provides the past data and it doesn't consider the potential profitability of a customer in the future.
2. Most of the companies and institutions do not have data capturing systems that can accurately estimate the customer revenues and costs.
3. There is no recognized method available to analyze customer profitability and results are also doubtful.
4. It is a challenge to the company to track the profitability of customers over a long period of time.
5. It is also difficult to measure the cost of acquiring customers and the cost of providing service to the customers.
6. Some people within the company (eg commission sales persons) do not want the CPA to be implemented because they try to protect some unprofitable customers.
7. A major problem in tracking customer revenue is that a customer may have many names and codings, due to which a computer may show more customers than the actual number of customers.
8. Sometimes, the companies may have incorrect and unclear data regarding the customers. This will lead to problems in the analysis.
9. Revenue recording issues may also arise while developing individual customer revenue numbers.
10. One needs to possess multiple skills to carryout CPA. Lack of skills may lead to the failure of analysis.

Q8. (a) A borrower of a bank is sanctioned ₹ 10 crores credit limit, but utilized only ₹ 8 crores on an average at contracted rate of 20%. The borrower will have to pay a commitment fee of 0.5% on the unused portion of the credit limit. The bank insists that the borrower maintains a margin of 20% for the utilized portion of the credit limit and 5% for the unutilized portion. The central bank imposes a reserve requirements of 10% of the deposits. You are required to find:

(i) The estimated loan revenue

(ii) The estimated bank funds outlay for the borrower and

(iii) The estimated before tax yield to the bank from this loan.

Answer :

Given that,

Sanctioned credit limit amount = ₹ 10 crores

Utilized credit = ₹ 8 crores @ 20%

Unutilized credit = ₹ 2 crores @ 0.5%

Margin requirements = 20% for utilized credit and 5% for unutilized credit

Reserve requirements = 10% of deposits

(i) Estimated Loan Revenue

= (Revenues from utilized credit) + (Revenues from unutilized credit)

= (8 crores × 0.20) + (2 crores × 0.005)

= 1.6 + 0.01

= 1.61 crores.

(ii) Estimated Bank Funds Outlay for the borrower

= Utilized credit – (Compensating balance + Reserves – Requirement)

= 8 crores – [(8 × 0.2 + 2 × 0.05) + 0.10 (8 × 0.2 + 2 × 0.05)]

= 8 crores – [(1.6 + 0.1) + 0.10 (1.6 + 0.1)]

= 8 – [1.7 + 0.10 (1.7)]

= 8 – [1.87]

= 6.13 crores

(iii) Estimated before Tax Yield to the Bank from this Loan

$$= \frac{\text{Estimated loan revenue}}{\text{Estimated bank funds outlay}}$$

$$= \frac{1.61}{6.13}$$

= 0.2626 (or) 26.26%

OR

(b) The current prime lending rate is 9% and the future interest rates are expected to be volatile and have Crax Bank wants to change floating rate on loans to its borrowers. For a particular borrower the bank decided to charge 350 basis points premium over the prime rate to cover for the risk. You are required to:

(i) Find the prime plus and prime time rates chargeable to the borrower.

(ii) If the prime rate increases by 1.5% and decreases by 1.5% how would the principles and prime time rates change to the borrower.

(iii) In case of increasing or decreasing interest rate which of the two methods are beneficial to the bank.

Answer :

Given that,

Prime rate = 9%

Premium desired = 350 bp

(i) Prime plus and prime time rates

(a) In prime plus or additive method, the loan price is calculated as prime rate + Desired premium

= 9% + 3.5 % = 12.5%

(b) In prime time or multiplicative method, the loan price is calculated as prime rate x Adjusting factor

$$\text{Adjusting factor} = \frac{9+3.5}{9}$$

$$= \frac{12.5}{9}$$

= 1.388 (or) 1.39 %

∴ Loan price = 9 × 1.39

= 12.5 %

(ii) If the prime rate increased by 1.5% and decreases by 1.5% the principles and prime time rates, are,

(a) If there is an increase in prime rate by 1.5% then the present price would be,

9 + 1.5 = 10.5 %

∴ The loan price using the prime plus method = 10.5 + 3.5

= 14 %

The loan price using the prime time method = 10.5 × 1.39

= 14.6 %

(b) If there is a decrease in the prime rate by 1.5%, then the present price would be

9 – 1.5 % = 7.5%

∴ The loan price using the prime plus method

= 7.5 + 3.5

= 11%

The loan price using prime time method

= 7.5 × 1.39

= 10.4%

(iii) Interpretation

In case of increasing prime rates by using prime time method, banks can gain high profits whereas in case of decreasing prime rates, banks can earn huge profits by using prime plus method of pricing.

Q9. (a) Describe the History and Development of Insurance Sector in India.

Answer :

History of Insurance Sector in India

For answer refer Unit-IV, Page No. 4.6, Q.No. 7.

Development of Insurance Sector in India

For answer refer Unit-IV, Page No. 4.7, Q.No. 8.

OR

(b) Explain the functioning of IRDA.

Answer :

Insurance Regulatory and Development Authority (IRDA) is an independent statutory body of India that governs and promotes the life Insurance and General Insurance Companies in India. Just like the role of head member in the family, IRDA ensures that fair practices are being adopted by Insurance companies to prevent loss of customers.

IRDA functions in the following manner to keep up the growth and to regulate the Insurance industry in India,

Powers/Duties/Functions of IRDA

For answer refer Unit-IV, Page No. 4.20, Q.No. 24, Topic: Duties and Power of IRDA.

Role of IRDA

For remaining answer refer Unit-IV, Page No. 4.21, Q.No. 25.

Q10. (a) Distinguish between life insurance and general business operations in detail.

Answer :

For answer refer Unit-V, Page No. 5.17, Q.No. 18.

OR

(b) Explain the settlement of claims mechanism in life insurance business.

Answer :

For answer refer Unit-V, Page No. 5.11, Q.No. 12.

UNIT 1

Introduction to Banking

LEARNING OBJECTIVES

After studying this unit, one would be able to understand,

- The Structure of Indian Banking System including Scheduled Commercial Banks, Foreign Banks.
- The Differences between Commercial Banks and Payments Banks.
- Types of Banking-Universal, Wholesale, Private and Retail Banking.
- The Evolution of Banking System in India, Nationalization and Different Banking Sector Reforms.
- Financial Intermediation by Banks.
- Functions of a Bank, Banking Sector and Organization of Banks.
- Different Types of Accounts.
- Various Services offered by Banks.
- Sources of Risk in Banks.
- Analyzing Banks Financial Statements.

INTRODUCTION

The banking structure in India consists of commercial banks, financial institutions, non-banking financial companies and co-operative credit institutions.

Commercial banks play an active role in the economy as it facilitates the mobilisation of savings, trade and commerce, balance regional development, etc. It performs variety of functions such as, traditional functions, ancillary functions, incidental functions and core functions.

The different types of relationships which exists between the banker and the customer are principal agent relationship, debtor-creditor relationship, bailor and bailee relationship, etc. A customer can be any entity (or) an individual carrying out transactions with the banks.

Banking sector reforms which were introduced during 1990's were based on the report of the committee which was under the guidence of Mr. M. Narsimham in the year 1991. This committee is termed as "Narsimham Committee". In 2009, financial sector reforms was formed under the committee for the guidance of Mr. Raghuram Rajan. Hence, it was known as "Raghuram Rajan Committee".

There are many types of risks associated with banking transactions such as, Interest rate risk, liquidity risk, credit risk and foreign-exchange risk. The Banks offers both traditional and modern services such as, saving deposits, safe keeping of valuables, demand deposits, grants consumer loans, financial advising, etc.

The Rating of 'CAMELS' is applied to Indian banks. The key performance indicators for banks are operating efficiency, expense control, tax management, liquidity and risk.

The banks offers different deposit schemes to its customers and the sources of bank-deposits can be catagorised under two groups- non-deposit funding sources and deposit funding sources.

The other sources of funds for banks are 'Equity and Reserves' and 'Borrowing'. The 'deposits' acts as the major sources of funds for banks.

1.1 STRUCTURE OF INDIAN BANKING SYSTEM

Q1. Describe the structure of Indian Banking System.

Answer : *Model Paper-I, Q6(a)*

The banking structure in India consists of commercial banks, financial institutions, non-banking financial companies and co-operative credit institutions. Each component can be studied as follows,

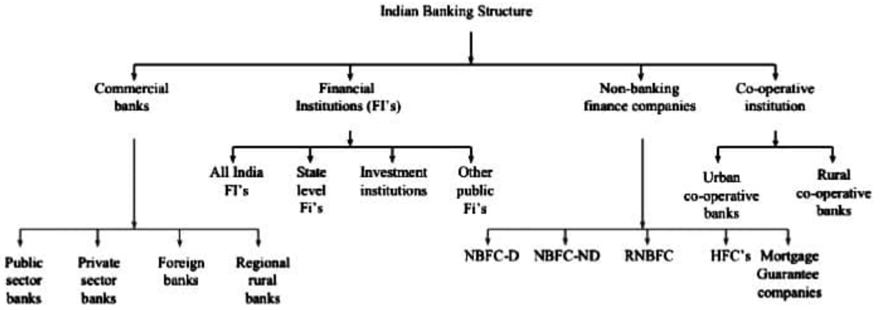

Figure: An Overview of the Complete Indian Banking Structure

1. Commercial Banks

Commercial Banks are business enterprises which are involved in finances, financial instruments and provide financial services for a price which maybe in the form of interest, commission or a discount and so on. "They accept deposits of money from the public (savings), for the purpose of lending or investment (to meet working capital requirements or corporates)".

Commercial banks are categorised as,

(a) Public sector banks

(b) Private sector banks

(c) Foreign banks

(d) Regional rural banks.

(a) Public Sector Banks

In India, public sector banks are regulated by the various laws and statutes proposed by the parliament. The board of public sector banks comprises directors in the form of chairman, managing director government nominee director, RBI's nominee director and some other elected directors and so on. Till the end of March 2009, the number of public sector banks in India were numbered to 27.(out of which 20 were nationalised banks was State Bank of India (SBI) and 6 were associates banks of SBI).

Example

State bank of India (SBI), Central Bank of India, Andhra Bank, Bank of Baroda, Punjab National Bank etc.

(b) Private Sector Banks

In March 2009 the number of private sector banks in India were found to be 22. Among them, 15 constituted the old banks while the remaining 7 were new private sector banks. The main purpose behind the allowance of private sector to own and operate banks was to ensure the diversification of ownership and control. New private sector banks are also permitted to enter the market with an initial capital of about ₹. 200 crores, which would increase to a total of about ₹. 300 crores in the next three consecutive years. In India for any private sector bank, the aggregate foreign investment is restricted to only 76% of the paid up capital. (i.e., the remaining capital must be contributed by the residents of a country).

Examples

Global Trust Bank Ltd., ICICI Banking Corporation Bank Ltd., Axis Bank, HDFC etc.

(c) Foreign Banks

In India, foreign banks can operate through any one of the following options,

(i) They can operate through the establishment of their own branches (may be in same country or in some other country).

(ii) They can also enter the market by establishment of the wholly owned subsidiaries.

(iii) They can also establish the partly owned subsidiaries with an maximum aggregate investment of about 74 percent (in any private sector bank).

Any foreign bank on establishing its first branch in India is required to invest an initial capital of about 25 million U.S dollars. In March 2009, the number of foreign banks in India were found to be only 32.

Examples

Bank of Tokyo Ltd., Citi Bank N.C. Standard Chartered Bank Ltd., American Express Bank etc.

(d) Regional Rural Banks

There were only 84 Regional Rural Banks in India by the end of March 2009. The main purpose of regional rural banks was to at deliver the rural credit facilities to the backward areas. Thereby, ensuring their financial soundness. Central government respective state government and sponsors (Commercial banks) are responsible for the contribution of initial capital base of RRBs. The regulatory framework of regional rural banks (RRB's) has been proposed by the Reserve Banks of India (RBI) and NABARD which helps in supervising their operations with some supervisory powers.

Examples

Andhra Pradesh Grameena Vikas Bank, Arunachal Pradesh Rural Bank, Baroda Gujrat Bank, Himachal Gramin Bank etc.

2. Financial Institutions (FI's)

Financial institutions form the second component of the IF's. Financial institutions are business organizations which deal with financial resources. They are the industrial sources of finance. It is a link between the savers and investors and helps in the credit allocation process financial institution's are necessary for the efficient functioning of the economy. By accepting the deposits from individuals and institutions, resources or funds are collected. Financial institutions then loan them to industry or trade. They take decisions regarding efficient use of scarce capital. They are involved in transactions of financial instruments. Financial institution (FI's) include,

(a) All India Financial Institutions (FI's)

(b) State level financial institutions

(c) Investment institutions and

(d) Other public FI's.

All India FI's comprises Exim Bank, NABARD, NHB and SIDBI. EXIM Bank in also known as "Term-lending institution", whereas NABARD, NHB and SIDBI constitutes the refinancing institutions. EXIM Bank makes direct investments in projects. Based on the nature of investment refinancing has to be carried out. For example, NABARD provide refinancing facility to agriculture and other allied activities. NHB extends refinance to housing sector whereas, for Micro, Small and Medium Enterprises (MSME), refinancing facility is provided by SIDBI.

State Financial Corporation (SFC's) and State Industrial and Development Corporations (SIDC's) are termed as state level "Financial institutions". Investment institutions comprises LIC and GIC. Under the companies Act 1956, the government of India announced "Public financial institutions" which includes Industrial Finance Corporation of India (IFCI) and Tourism Finance Corporation of India (TFCI).

3. Non-banking Finance Companies (NBFC)

NBFC's are financial intermediaries whose main function is to accept deposits and deliver credit. They are responsible for channeling financial resources which maybe scarce for capital formation. They aid the banking sector in meeting the financial requirements of the corporate sector. As compared to banks NBFC's are flexible, quick, efficient and customise services as per the requirements of the clients. NBFC's provide services which may include,

- Hire purchase finance
- Equipment lease finance
- Loans
- Investments
- Factoring services
- Credit rating agencies
- Venture capital funds.
- Merchant banking organization.

4. Co-operative Credit Institutions

The functions of cooperative banks are,

(i) Co-operative banks provide loans to the farmers and artisans at low rate of interest and thereby they are protected from the oppression of the Mahajans.

(ii) Farmer's income and their standard of living is being developed and improved due to co-operative banking.

(iii) Agricultural production increases because farmers are granted loans by the co-operative banks for purchasing good seeds, fertilizers and cattle.

(iv) The members of the co-operative banks exercise an effective control on their activities due to the unlimited liability of the banks. This results in social awareness.

(v) Co-operative banking inspires to utilize the funds and even small savings of the people carefully.

Q2. Write about the various functions of commercial banks.

Answer :

The functions of commercial banks are basically divided into the following two types,

I. Primary functions

II. Secondary functions.

I. Primary Functions

The primary banking functions of commercial banks are,

1. Acceptance of deposits from the public

2. Creating credit.

1. Acceptance of Deposits from the Public

The primary/basic function of the commercial banks is to accept the savings as deposits from the public and to mobilise such savings of the household section. Usually the commercial banks offer three types of deposits on the basis of the needs of different classes of depositors.

(a) Demand Deposits

It is also known as "Deposits in current account", because the depositor can easily withdraw the deposited amount at any time.

(b) Saving Deposits

Commercial bank offers this type of deposits in order to motivate the people for savings especially from households.

(c) Fixed Deposits

It is also known as "Time deposit". Incase of fixed deposits the amount deposited can be withdrawn only after the expiry of a fixed time period.

(d) Other Deposits

Commercial banks also provide deposits such as recurring deposits, old age pension scheme, health benefits etc.

2. Creating Credit

The second important primary function of the commercial banks is the creation of credit by providing loans and advances. The banks keep a small sum total deposits as its cash reserve. It is the central bank who decides the size of the cash reserve and the excess of that cash reserve is utilized by the banks for credit purpose/derivative deposits in the following ways,

(a) Overdraft is a short term loan wherein the customer can withdraw excess amount from his current a/c upto certain fixed extent.

(b) In cash credit the amount which can be withdrawn from the account is transferred to a separate account and is similar to that of overdraft.

(c) Loans and advances are usually provided by the banks either against the hypothecation of inventory or mortgage of any fixed assets.

(d) The commercial banks performs the function of discounting bills of exchange in order to provide quick finance for the working capital.

II. Secondary Functions

(i) The commercial banks acts as an agent of its client and collect or pay interest, rent, dividends and insurance etc.

(ii) The commercial banks may also buy and sell the securities of its clients.

(iii) It protects the valuables like confidential documents of its clients by providing bank lockers or safe deposits vaults to its customers.

(iv) It provides credit information to its clients by issuing letter of credit, under writing loans, credit-standing etc.

(v) It also provides facilities like foreign exchange transfer of money from one branch to another branch, person-to-person and so on.

1.1.1 Scheduled Commercial Banks, Foreign Banks

Q3. Define scheduled commercial banks. Explain in detail about the classification of scheduled commercial banks.

Answer :

Scheduled Commercial Banks

The Scheduled Commercial Banks (S.C.Bs) constitute those banks which have been included in the second schedule of RBI Act 1934, vice-versa for unscheduled CBs.

The S.C.Bs are further classified or subdivided by RBI as public sector banks, old private sector banks, new private sector banks and foreign banks.

The composition of S.C.Bs in India are 300, which includes the SBI and its associated banks (8), nationalised banks (19), private sector banks (32), RRBs (196) and foreign banks (45). During 1994-95, ten more banks were added in the S.C.Bs and the Bank of Karad was taken over by Bank of India. The total number of branches of S.C.Bs is 64,918 of which 36679 (56.5%) were located in rural areas, on 30th June, 1999.

Classification of Scheduled Commercial Banks

Reserve bank of India Act, 1934 comprises scheduled commercial banks in its second schedule. Scheduled commercial banks are further divided into four categories,

1. Public sector banks
2. Private sector banks
3. Foreign banks in India and
4. Regional rural banks.

There are 81 scheduled commercial banks out of which 26 constitutes the public sector banks, 21 are reserved for private sector banks whereas the remaining 34 belongs to foreign banks.

1. Public Sector Banks

Government has the chief authority in public sector banks. Public sector banks broadly classified into two categories,

(a) State bank of India and its associates and

(b) Nationalised banks.

(a) State Bank of India

The state bank of India was introduced on July 1, 1955.

The five subsidiaries under the state bank of India includes the State Bank of Bikaner and Jaipur, the State Bank of Hyderabd, the State Bank of Mysore, the State Bank of Patiala and, the State Bank of Travancore.

The state bank of India is the largest commercial bank, in the world with an aggregate of nearly 16055 branches comprising 4607 branches of its associate bank, 131 foreign offices in 32 countries and 2410 ATMs networked with SBI ATMs in India. SBI holds a total of 17% market share with an asset base of about ₹ 542503 crore. It is considered as the country's largest bank wherein there exists 100 million accounts with a total workforce of about 2,14,845.

SBI has funded 17 RRBs till March 31, 2009. SBI has five non-banking subsidiaries,

The current plan of SBI is to make itself as "Universal bank" which helps in meeting the different needs of the society through reformation of its branches into 'super shoppe' wherein its products such as banking, insurance, mutual funds and credit cards would be sold.

(b) Nationalised Banks

Banks are nationalised under the banking companies Act, 1970. This phase of nationalisation constitutes the second stage of nationalisation. In 1969, nearly fourteen big Indian joint stock banks belonging to the private sector undergone the nationalisation process. During the third stage of nationalisation, six commercial banks in the private sector with an average deposits of over ₹ 200 crores were nationalised on August 15, 1980. Presently, there are 27 nationalised Banks, the state bank of India and its six associates and 19 nationalized banks and IDBI. The main objective for nationalisation was to provide financial assistance by network to the rural and semi urban areas.

From there onwards, the Nationalisation of banks commenced. The objectives of Nationalised banks were,

(i) To provide major banking facilities exclusively to the rural and semi-urban areas.

(ii) To spread awareness of agricultural finance and to overcome the causes for the downfalls of the agricultural finance system.

(iii) To facilitate the reserve bank in the formulation of its credit policies.

(iv) To provide assistance to the government in carrying out the broad economic policies.

2. Private Sector Banks

The Narasimham committee, stated in its report that the RBI should allow the establishment of new banks if they are capable of fulfilling the minimum start-up capital and other requirements. And also stated that there should be no discrimination between the public sector and private sector. The banks established after the committee report are known as new private sector banks.

In a recent scenario there exists 21 private sector banks out of which 14 banks are old whereas, the remaining banks are new banks. New banks generated profits from the first year itself. The public sector banks are facing heavy competition from the private sector banks.

In January 2001, the guidelines relating to the establishment of new private sector were updated or revised.

(a) It recommended to raise initial minimum paid-up capital from ₹ 100 crore to ₹ 200 crore. Further, the initial minimum paid up capital shall be increased to ₹ 300 crore in the next three consecutive after the establishment of a business enterprise.

(b) It allowed a Non-Banking Finance Company (NBFC) to transform into a commercial bank if it satisfies the following conditions,

(i) Establishes with a total minimum net worth of ₹ 200 crore.

(ii) Holds a credit rating of 'AAA' or its equivalent ratings in the previous year.

(iii) Sufficient capital of less than 12 percent and

(iv) Net NPAs whose worth should not be more than 5 percent.

(c) The guidelines restrict the huge industrial houses to advertise any new bank. The individual firms associated directly or indirectly with large industrial houses are only allowed to contributes a maximum of 10% in the total equity of a new private sector bank.

(d) The option would be provided to those promoters who are having expertise in financing the priority areas and also in establishing banks which are specialised in financing the operations of rural agro-based industries.

3. Foreign Banks in India

A survey conducted identifying the number of foreign banks in India on April 30, 2010. A total of 34 foreign banks have been identified in India with 311 branches. Furthermore, 45 foreign banks are operating in India by establishing their representative offices. The standard chartered bank consists of the highest number of branches (i.e., 92) among all foreign banks in India.

Some foreign banks have been operating in India over the hundred years. For instance ANZ Grindlays and standard chartered banks have been operating in India for more than a decade. Few foreign banks have established various entities that are operating in India as subsidiaries constituting either the non-banking financing companies or limited companies in the non-financial sector which comprise different businesses like dealing in securities, leasing and finance, information and technology.

Examples : HSBC, Bank of America and so on.

The RBI guidelines for foreign banks in India,

(a) In the first stage, from March 2005 to 2009, the eligible foreign banks were allowed to establish their presence by initiating a wholly-owned banking subsidiary or by converting the existing branches into a subsidiary.

(b) For making the presence, the wholly-owned banking subsidiary is required to have a minimum capital of ₹ 300 crore and a strong corporate governance for its operations.

(c) In the second stage in April 2009, the new foreign banks were permitted to operate in India if the banks were found to be financially sound wherein they consider the international and home country ranking, rating, international presence and economic and political relations between the two countries.

(d) The minimum capital stipulated is USD 25 million has to be divided among 3 branches where the first two branches get a capital of about USD 10 million while the remaining amount of USD 5 million must be allocated to the third branch. More branches are allowed after observing the operations of present branches. 12 licenses are determined in compliance with India's commitment make to WTO, per annum for new and for expanding the existing banks.

(e) Foreign banks are required to lend an aggregate of about 32% of their adjusted net bank credit or credit equal to the off-balance sheet exposures, whichever is found to be more.

4. Regional Rural Banks

The main purpose of regional rural banks was to at deliver the rural credit facilities to the backward areas Thereby, ensuring their financial soundness. Central government respective state government and sponsors (Commercial banks) are responsible for the contribution of initial capital base of RRBs. The regulatory framework of Regional Rural Banks (RRB's) has been proposed by the Reserve Banks of India (RBI) and NABARD.

Examples

Andhra Pradesh Grameena Vikas Bank, Arunachal Pradesh Rural Bank, Baroda Gujrat Bank, Himachal Gramin Bank etc.

1.2 COMMERCIAL BANKS VERSUS PAYMENT BANKS

Q4. Distinguish between commercial banks and payment banks.

Answer :

Following are the differences between commercial banks and payment banks,

	Basis	Commercial Banks	Payment Banks
1.	Loans	Commercial banks can give loans.	Payment banks cannot give loans.
2.	Credit Cards	Commercial banks can issue both credit and debit cards.	Payment banks are not allowed to issue credit cards.
3.	Deposits	Commercial banks can take deposits without any limit in both urban and rural areas.	Payment banks are restricted to take deposits upto ₹ 1 lakh per person.
4.	Business Correspondents	These banks associates with payment banks in the country and thus act as business correspondents.	These banks combine with other commercial banks and act as business correspondence in away to strengthen opportunities of both entities.
5.	Minimum capital	The capital of commercial banks are always in a maximum level and their balance sheet is also immense.	There should be a minimum capital of ₹ 100 crores for the payment banks, so that the promoters can contribute not less than 40% of the capital.
6.	Foreign Holdings	These banks follow the same policy that is common for FDI in the banking sector.	Payment banks also follow the same policy as commercial banks that is common for FDI in the banking sector.
7.	Customer Grievance Cell	Commercial banks considers all requests and concerns of bank account holders.	These banks also considers all requests and concerns of bank account holders.
8.	Financial Products Distribution	Commercial banks can act as a middle man in order to serve the needs of financial products of individuals.	Payment banks can take part in the distribution of financial products like mutual fund schemes, insurance etc.

1.3 TYPES OF BANKING – UNIVERSAL BANKING, WHOLESALE BANKING, PRIVATE BANKING, RETAIL BANKING

Q5. Explain about various types of banking in detail.

Answer :

Following are the various types of banking systems. They are,

(i) Universal banking

(ii) Retail banking

(iii) Wholesale banking

(iv) Private banking.

(i) Universal Banking

Universal banking signifies broad-based and comprehensive banking activities that deals with working capital requirements as well as term loans for developmental of individual customers and big corporates. It is also referred as the developmental phase of financial markets which acts as a link between banks and industry. They undertake financial services and fund based activities. These banks have explored the lines of business activity by integrating the functions such as, traditional deposit taking, modern financial services, selling long term saving products, insurance cover, investment banking etc.

Some of the examples of Universal Banking are Citi Bank. Hong Kong and Shanghai Banking Corporation (HSBC). In India State Bank of India (SBI), Indian Overseas Bank (IOB) are some of the examples of universal banking.

(ii) Retail Banking

Retail banking is the method through which banks approaches the customer for selling their products. It is a kind of commercial banking system where banks focuses on individual customers instead of corporate clients retails banks offers customer-oriented products such as offering a car loan, home loan facility, financial assistance for purchase of consumer durables etc. They also provides various products and services to individuals and small businesses. The traditional retailbank provides the services of intermediation and payment services. Further, they also offer an extensive scope of products/services including insurance products, pension schemes, stock broking services etc. Majority of the banks in rurual and semi-urban areas conducts retail banking services.

(iii) Wholesale Banking

Wholesale banking is also referred as corporate banking. It deals only with large-size of customers and maintain only large accounts through which a few transactions with large-sized customers results in large amounts with cost reduction and higher fees. These banks do not believe in maintaining thousand of small accounts and earning huge transaction costs.

Foreign banks in India mainly focuses on wholesale banking with the cooperation of fully computerized banking operations. The growth of wholesale banking is achieved by increased activities of merchant banking and investment banking.

(iv) Private Banking

Private banking is also referred as personal banking. Private banking services aids to the need of individual customers their preferences and personal services like maintaining accounts, loans, foreign currency requirements, investment guidance etc. This type of banking system are individual oriented with investment and asset management and they do not aid the needs of industry and trade.

1.4 EVOLUTION OF BANKING IN INDIA – NATIONALIZATION, BANKING REFORMS

Q6. Describe briefly about the evolution of banking system in India.

Answer :

The evolution of the Indian banking system is divided into four different phases which are as follows,

1. The Pre-independence (pre-1947) Phase

During this period, many banks were established as there were not set standards for entry. Some banks which exist even today are the result of the Swadeshi movement. This phase witnessed the failure of several banks and was marked by two world wars and great depression. The global pressure and mismanagement of banks were the two major reasons for the failure of the banks. The RBI was therefore established in 1935 to overcome such failures. The absence of an appropriate regulatory framework restricted the control of RBI over the banks.

2. 1947 to 1967

The Banking Companies Act was introduced in 1949 in the post-independence era, for solving the issue of banking failures. The safety and soundness of the banking sector was improved by the RBI. This act also granted the authority of regulating and controlling the banking sector to the RBI. The introduction of deposit insurance boosted the confidence of the depositors in the banking system. The banking system was also expanded in the rural areas. RBI's efforts to ensure adequate credit to productive sectors resulted in the development of complex regulated interest rate structure.

3. 1967 to 1991-92

Strict social controls over the banking sector were witnessed from 1967 to 1991-92. Direct lending to the 'priority sector' was introduced for assuring equal flow of credit to agriculture and small sectors. The banks expanded rapidly without considering the profitability and asset quality. The medium and large firms faced the credit problems due to strict targets for the priority sector lending. This resulted in the acquisition of many non-performing assets by the banks.

In 1990s, the financial sector of India had the following characteristic features,

- Controlled and regulated interest rates.
- High rates of CRR and SLR which resulted in the withdrawal of large amount of resources from productive lending.
- The extensive flow of small funds among the banks.
- The accounting practices were not transparent and has limited disclosure.
- There was large public ownership and decreased efficiency and productivity.
- There was small amount of capital and large amount of non-performing loans.
- Huge investment was made in government bonds which facilitated high government borrowing at concessional interst rates.
- There were shift barriers for the entry of new and efficient players in the banking sector.
- There was limited access to private sector banks.

This phase also witnessed lack of depth in the capital and foreign exchange markets. The development of the financial system was also restricted as monetary policy was given less importance than the fiscal policy.

4. 1991-92 and Beyond

1991-92 was one of the most productive phases in India's banking history.

This phase is divided by RBI into two sub phases : 1991-92 to 1997-98 and beyond 1997-1998. In the first phase, a powerful committee on the financial system was established by the government under the chairmanship of Mr M. Narismham. This committee became popular by the name of 'Narsimham communittee'.

The five principles that guided these reforms were (1) Cautious and sequenced reform measures (2) Introduction of reinforcing standards (3) Introduction of complementary reforms (4) Development of financial institutions and (5) Development and integration of financial markets.

The first sub phase focussed on improving the profitability, competitiveness, capital position and asset quality of banks. Risk aversion was also developed by banks.

The second sub phase of 1997-98 showed a shift towards the prudential standards with the international best practices. The private sector banks were permitted to operate which lead to an increase in the competition. The number of non-performing assets were decreased sharply. During this phase the technology was introduced into the banks.

A high level committee was established in 2007 under speeding the chairmanship of Prof. Raghuram Rajan for speeding the financial sector reforms. The following are the committee's terms of reference,

(a) Recognizing the emerging challenges for fulfilling the financing needs of the Indian economy and identifying real sector reforms which helps those needs to be met easily by the financial sector.

(b) Analysing the performance of the different segments of financial sector and recognising changes which helps in meeting the needs of real sector.

(c) Identification of changes in the regulatory and supervisory infrastructure which facilitates the financial sector to play its role.

(d) Identification of changes in the areas of economy and the conduct of monetary and fiscal policy.

Annexure 2 presented 35 proposals which was created by the committee. Annexure III outlined the major policy and legal reforms which occurred in the Indian banking sector since 1991-92.

Q7. Explain the commercial banking scenario in India after nationalization.

Answer :

The period following the nationalizations of banks was dominated by the bank's expansion at a path breaking pace. As many as 50,000 bank branches were setup. Three-fourth of these branches were opened in rural and semi-urban areas. During this period, a distinct transformation of far reaching significance occurred in the Indian Banking System.

With the completion of this transformation process, the basic objective of banks was accomplished and the banking industry achieved unparalleled growth in terms of reach and employment. Thus, the growth has resulted in loss of control over widely spread offices. Retail lending to risk-prone areas at concessional rates had raised costs, affected the quality of assets and put their profitability under strain.

The competitive efficiency of the banks was at a low ebb. Performance of a bank was measured merely in terms of growth of deposits, advances and quality became a casualty. However, in the late eighties, measures were initiated to reduce the structural constraints which were then inhibiting the development of money markets.

In the nineties, the banking sector contributed to a great extent in creating a vital infrastructure for nation building. Generating employment opportunities and expanding business.

The banking sector, during the course of its expansion suffered from many deficiencies with regard to their efficiency and quality of their operations. The factors that contributed to inefficiencies were :

- Over-regulation led to Weakening of the management functions due to over regulation.
- Directed lending which curtailed the innovative skills of the banker.
- Loan write-off when completely eroded the basic character of banking business.
- Day to day interferences by the trade unions resulted poor work culture.
- Too much expansion at a fast pace which has adversely affected quality of bank assets and its profitability.

Q8. Write a brief note on banking reforms we have seen in India in the last two decades.

Answer : *May/June-16, Q2(b)*

Many prudent norms were introduced for income recognition, asset classification, provisioning of liquid loans and capital adequacy in the banking sector. To increase the competition, new private sector banks were permitted to enter. The number of categories were reduced for rationalising the directed credit. The banks were free to relocate branches, establish specialized branches and open new branches without the permission of the RBI, as a result

of liberalisation of branch licencing policies. The restrictions/ limit specified for borrowings under certificates of deposits were withdrawn. There was also a reduction in the interest rate subsidy on the priority sector lending and there was also a partial deregulation in the interest rates on the deposit and lending sides. The government's anticipation of bank's resources by SLR and CRR was reduced in stages.

The framework of the financial sector is changing at a fast pace. There has been the introduction of many new private banks, FIIs and AMCs. The services such as consumer finance, project finance, advisory services, credit cards and merchant banking services were also taken up by the banks. The commercial banking and investment banking was started as the development of the financial institutions dominated the banks. The NBFCs are widening their services or activities for managing their survival. The growth of homogeneity in the activities of the segmented industry is changing the competitive forces.

The improvement in the financial condition of the commercial banking sector in relation to the asset quality, capital adequacy and profitability has been the most remarkable achievement of the financial sector reforms. In spite of this, there are several challenges faced by the commercial banks,

1. The high spreads and cost of intermediation and the transformation of the banking sector into more efficient, productive and competitive set up are the major problems faced by the banking industry.
2. The banks are likely to face difficulties in maintaining their capital levels in future eventhough they have more than the minimum prescribed capitalisation level. The credit demand and the implementation of new capital accord is expected to increase the capital requirements of banks. The bank's ability to generate limited amount of funds internally and the depressed capital market conditions proves to be a major challenge for maintaining the capital position of the banks.
3. The overhanging of NPAs, attributable to the systematic factors like weak debt recovery mechanism, non-reliability of collateral and poor credit appraisal techniques continue to be the problem for commercial banks. Mixed results were generated through policy measures. The enforcement of Security Interest Act, 2002 has proved to be helpful for NPAs for increasing the momentum for recovery.
4. The regulated regime divided the market into different categories and managed the credit risk individually. The reserve bank is preparing the banks for proactive risk management and helps them to overcome the risks. Technical systems and management processes should be developed by banks for recognising the risks involved in their activities and for effectively measuring, monitoring and controlling them.
5. The quality corporate governance plays an important role when the competition increases, ownership diversifies and banks focus on retaining their client base. Therefore, the means and measures for corporate governance should be possessed by the financial institutions. The internal management systems of the banks should be improved by the banks.
6. An effective and well diversified banking system anticipates about the development of the banking sector with a wide array of well-capitalised and healthy banks. The ownership of banks continues to be an issue. The public sector banks act as the dominating force in the Indian banking sector till date. Diversification of ownership is essential for making them amendable to market discipline and reducing the chances of regulatory forbearance.
7. Lastly, the bank lending is procyclical whereas the NPAs tend to be in counter-cyclical fashion. Subsequently, as the condition of the borrowers deteriorates. The banks continue downgrading such borrowers. Such behaviour of the banks makes the cyclical fluctuations more noticeable.

The risk management was not a part of banks till last five years. But in the present environment, as the banks are facing increased amount of risk it has become very essential for the banks to manage the risk. Asset quality, foreign risk management asset-liability management and productivity and efficiency are some of the major issues on which the banks focus.

The bankers are focusing on improving recoveries, boosting treasury operations, focusing on fee based income, opening specialised branches and increasing computerization level for increasing the operating profitability.

The banks should also focus on the recovery of non-performing loans. Recovery branches have also been established by some banks for this purpose. Different packages are offered to the borrowers which can be selected as per their abilities. Each bank keeps a task force for the realisation of the dues.

The regulation and self-regulation go together. Therefore, self-regulatory organisations are established for monitoring the activities and for laying down the rules and settling the disputes.

The first phase of reforms has proved to be successful for the banking sector. The banking sector is looking forward for the 2nd generation of reforms. The second generation reforms should focus on making the banking system more efficient and sound.

There has been an improvement in the bank's capital position with the introduction of various reforms in the banking sector.

The creation of good and responsive banking system results in the efficient functioning of financial services and leads to universal banking. The universal banking provides several services under a single roof. Even though the competition increases, the banking industry is sure to achieve higher degree of efficiency. The new scenario enables the firm to explore new territories. Credit/debit cards, mortgage finance, infrastructure lending, leasing and factoring are some of the activities that are gaining importance. Therefore, the new reforms in the Indian banking sector will make a qualitative difference.

Q9. Discuss the recommendations of Narasimhan Committee for the banking reforms in India.

Answer : *(Model Paper-I, Q6(b) | May/June-17, Q3(b))*

The report submitted by the committee headed by Mr. M.Narasimham in 1991 resulted in the development of some of the major reforms in the banking sector of India in 1990s. This report was submitted by the Narasimham Committee I and the following are some of its major recommendations,

1. There should not be any restrictions on establishing new banks in the private sector, if the banks meet the RBI requirements and have the required start-up capital.
2. A clear cut indication of no further nationalisation of banks should be indicated by the government and the public sector banks and private sector banks should be treated equally.
3. The banking system must grow towards a wide pattern, consisting of three or four large banks, involving State Bank of India which can become international, then around eight to ten national banks having network of branches all over the country and carrying out universal banking should be established. Every region must have a local bank and for meeting the needs of rural areas, rural banks must be established.
4. An Asset Reconstruction Fund (ARF) should be established. The ARF should be responsible for taking over a part of bad and doubtful debts, of the banks and financial institutions, at a discount level which is determined by auditors based on the defined guidelines. Special powers for the recovery of bad and doubtful debts should be granted to ARF. The public sector banks and the financial institutions should contribute the capital for the ARF.
5. The banks and financial institutions must be given the authority for recovering bad debts by the special tribunals. The value of recovery amount should be given by a panel which consists of two independent auditors.
6. The public sector banks carrying out profitable operations should be permitted to raise capital through the issue of mutual funds.
7. Branch licensing must be abolished and the banks should be permitted to open and close branches at their will except for rural branches. The internal management of the banks should also be left upto the banks.
8. The CRR and the SLR should be reduced.
9. The banks should maintain the prescribed Capital Adequacy Ratio (CAR) and should achieve 8% CAR by 1998.
10. To oversee the operations of banks a financial supervision board should be established.
11. Prudential income recognition norms should be followed by the banks for provisioning against bad and doubtful debts and for ensuring transparency in maintaining the balance sheets.
12. Computerisation should be implemented immediately into the banking industry.

As per the committee, that the foreign banks should meet the same requirements of the Indian banks and RBI must liberalise its policies for opening new branches by foreign banks. Joint ventures among foreign and Indian banks must also be allowed with respect to merchant banking, investment banking and other financial services.

The committee also recommended the removal of concessional interest rate as it was very complex and rigid. It suggested further deregulation of the interest rate for reflecting and emerging market condition.

Most of these recommendations have been implemented. After the establishment of WTO a more efficient and competitive committee was set-up by the government. This committee was also lead by Mr. Narsimham.

Narsimham Committee II

On April 1998, a second report had been submitted by the Narsimham committee. The following are the major recommendations made by the Narsimham committee II report,

1. The 'narrow banking' concept must be brought into trial for restoring weak banks. In case of failure, the issue of closure must be analysed. The narrow banking concept as per the committee means that the weak banks must not be allowed to invest funds anywhere, except in government securities.
2. International banking status should be given to two or three large Indian banks.
3. The small local banks must be restricted to a state or a group of districts for serving local businesses, small industries and agriculture.
4. The government's role in public sector banks was also specified/outlined by the committee. Such detailed management was considered as the reason for restricted growth and flexibility of banks.

5. The functions of boards and management must be reviewed to hold the board responsible for enhancing the value of share holders by the formulation of corporate strategy.
6. The CAR should be increased to 10 percent by 2002.
7. The prudential and disclosure norms and procedures should be laid down for serving the purpose of supervision and regulation.
8. The WBFC's lending activities must be integrated with the financial system.
9. The public sector banks must speed up computerization and emphasis on relationship banking.
10. The recruitment procedures, training and remuneration policies of the public sector banks should be reviewed.
11. The committee recommended that the issue related to the threat of action by vigilance and other investigative authorities must be addressed in the right manner.
12. The bank boards should be professionalized and depoliticized.
13. It lastly recommended the abolition of the banking service recruitment boards.

Q10. Discuss the measures taken by the Narasimham committee-II and the Verma committee to address the problems of the banking sector.

Answer :

According to the Narasimham Committee-II a 'weak bank' is the one whose total losses and net NPAs are more than its net worth or whose adjusted operating profits i.e., operating profit minus income on recapitalisation bonds, has been negative for the last three years. On the basis of this, the Verma committee on restructuring of weak banks which was established by the RBI in February 1999 has recognised three banks as weak banks. The Verma committee which submitted its report in October 1999, has traced out seven factors comprising three areas for the division of a bank as weak as follows,

1. Solvency i.e., capital adequacy ratio and coverage ratio.
2. Earning capacity i.e., return on assets and net interest margin.
3. Profitability, i.e., ratio of operating profit to average working funds, ratio of cost to income and ratio of staff cost to net interest income and addition to all other income.

The reforms process in banking sector is being developed in order to improve the efficiency and competitiveness of the sector. Ultimately the consequences of these reforms was that two out of the three weakly identified public sector banks namely UCO bank and the United Bank of India were transformed into profitable units by following turn around strategy. Besides this, the major point of concern with respect to banking industry was that the non-performing assets of banks proportion was growing and amounted nearly one lakh crore. Non-performing assets comprise assets basically in three categories, as follows,

(i) Sub standard

(ii) Doubtful, and

(iii) Loss.

Sub standard asset remains as NPA for a period less than or equal to 12 months while doubtful assets remains as NPA for more than 12 months. A loss asset is such a NPA which is traced out by the bank or internal/external auditors or by the RBI inspection as loss but whose amount is not being written off. On the basis of the recommendations of both the Narasimham committee-II and the Verma committee, few remedial measures have been taken up to solve the problems of the banking sector. They are as follows,

1. Large number of debt recovery tribunals and appellate tribunals were established in order to help in taking quick official decisions and recover the banks and financial institutions' dues. Therefore, detailed amendments have been made for the recovery of debts due to banks and Financial Institutions Act, 1993 with the issuance of an ordinance.
2. A credit information bureau is being established in order to control the increase of new NPAs.
3. Legislative provisions have been altered in order to work as per the boards of banks and to allow them to make decisions with respect to corporate strategy and make them accountable towards shareholders.
4. Greater number of means have been organised for DRTS to recover the bad debts. Besides this, the RBI has formulated guidelines to assist the recovery process and has recovered the loans upto ₹ 10 crores or less basically to tally the balance sheet of banks. The bank chiefs have been authorised by the government to recover loans more than ₹ 10 crore.
5. The government has initiated voluntary retirement scheme for the banking sector in order to decrease the staff cost of public sector banks.
6. With respect to bank's investment in shares and equity financing, fair and apparent guidelines are being framed.
7. The banking service recruitment boards were eliminated/removed. Therefore, the banks were being advised to make their own recruitment strategies by seeking the permission from the respective boards in order to meet the upcoming staff needs.
8. So far, 29 debt recovery tribunals and 5 appellate tribunals have been established.

9. The Deposit Insurance Credit and Guarantee Corporation are being transformed into the Bank Deposit Insurance Corporation in order to use it as an effective tool for coping up with depositors's risks and distressed banks.
10. Banks have established independent recovery units.
11. Development of legal cells of banks was practised.

Q11. "In 2009, Raghuram committee was formed with certain recommendations". Elucidate.

OR

Write about the recommendations of Raghuram committee, 2009.

Answer :

The Raghuram Rajan committee on financial sector reforms was formed in 2009. The following are the main recommendations made by the Raghuram Rajan committee,

I. The Macroeconomic Framework

Proposal 1

The RBI must have a single goal of staying close to the low inflation number of within a range and move steadily to a single instrument in the medium-term and achieve it through short-term interest rate.

Proposal 2

The foreign investors should be allowed to invest in the rupee corporate and government bonds after placing a clear monetary policy framework.

II. Broadening Acess to Finance

Proposal 3

The private well-governed deposit taking small finance banks which offsets higher risk must be permitted to enter. Significant efforts must be made for creating supervisory capacity for delivering greater monitoring to these banks and for taking increases for ensuring that these banks do not become public charges.

Proposal 4

Facilitating the wide range of local agents to extend financial services by liberalising the banking correspondent regulation. Reducing cost and limiting fraud and misrepresentation by using technology.

Proposal 5

The firms which are lending to eligible categories in the priority sector should be offered priority sector loan certificates (PSLC).

Proposal 6

The interest rate charged by the institutions for assuring that the credit reaches the poor can be liberalised but needs (a) Full transparency of annual interest charged on borrower's loan (b) Public disclosure of maximum and average interest rate charged to the priority sector and periodic basis and (c) only those loans are eligible for PSLCs which stay within the margin of local estimated costs of lending to the poor.

III. Leveling the Playing Field

Proposal 7

Small underperforming public sector banks should either be sold to other banks or to strategic investors.

Proposal 8

Developing strong boards, which grant more power to the share holders have the power to appoint and compensate the top executives to the board, for large public sector banks.

Proposal 9

Removing the government-controlled boards, once the process of strengthening the boards starts.

Proposal 10

Liberalizing the policies related to take overs and mergers and also the incorporated subsidiaries of foreign banks.

Proposal 11

Allowing the banks to establish branches and ATMs at any place.

Proposal 12

Permitting the holding company structures, wherein the parent company which owns the subsidiaries is responsible for their regulation. The financial sector oversight agency supervises the holding company.

IV. Creating More Efficient and Liquid Markets

Proposal 13

The Securities and Exchange Board of India (SEBI) should include all the regulations of trading.

Proposal 14

Supporting the introduction of exchange traded interest rate and exchange rate derivatives markets and other missing markets.

Proposal 15

Banning the markets to avoid investor's uncertainty and taking direct action against those responsible for manipulation.

Proposal 16

Introducing the concept of consolidated membership of an exchange for the qualified investors. The consolidated membership should grant the right to trade all the exchange's product on a single trading screen along with the consolidated margins.

Proposal 17

Supporting the establishment of professional markets and exchanges with a large order size which are restricted to the sophisticated investors.

Proposal 18

Creating a friendly environment, approving the products, and speeding up the process, by focusing on systematic risk, fraud, contract enforcement, transparency and inappropriate sales practices.

Proposal 19

Permitting increased participation of foreign investors in domestic market and increasing the number of domestic investors by minimising the restrictions of choice of investment. Focusing on granting access to suitable equity linked products to a wider population, and making it a part of inclusion agenda.

V. Creating Growth Friendly Regulatory Environment

Proposal 20

The financial sector regulations should be rewritten with clear objectives and regulations principles.

Proposal 21

With the finance ministry's opinion and opinion of experts a specific remit for each regulator must be set for every five years by the parliament. Each regulator must report every year to the standing committee. The annual reports should be explained and the interaction should be done in public.

Proposal 22

The regulatory actions must be appealed to the financial sector appellate tribunal. This tribunal will be established in the same way in which the securities appellate tribunal was established.

Proposal 23

The RBI should supervise all the deposit taking institutions. The shared responsibility should be ceased. The supervisory capacity should be increased by the RBI for this task. Even though it involves constitutional issues, the committee recommends the abolishment of shared responsibility system.

Proposal 24

The SEBI must review the accounts of listed companies and the Ministry of Corporate Affairs (MCA) reviews the accounts on unlisted companies.

Proposal 25

The status must establish a Financial Sector Oversight Agency (FSOA). The focus of FSOA is macropudential and supervisory. The periodic assessment of macroeconomic risks, risk concentrations and risk exposures in the economy will be done by FSOA. It will also monitor the functioning of large systematically important and financial conglomerates.

Proposal 26

A working group must be established which should focus on the financial sector reforms and should have the finance minister as its chairman. Its main focus is to guide or direct the financial sector reforms.

Proposal 27

Establishing an office of the financial ombudsman and inter linking all such offices acts as an interface between household and industry.

Proposal 28

The capacity of the deposit insurance and credit guarantee corporation should be strengthened for monitoring risk and resolving a failing bank.

VI. Creating a Robust Intrastructure for Credit

Proposal 29

Introducing the process of developing unique ID number with biometric identification.

Proposal 30

The committee recommended the change in the system of information sharing from reciprocity to subscription. In this system, the information is gathered from several sources and the subscriber is permitted to access this information after he has been authorized. The basic requirements for sharing the information must be decided and the incentives for providers of information needs to be reconsidered.

Proposal 31

The committee recommended the improvement in land registration and made the land registration compulsory. It also recommended the introduction of computerization in land records and establishment of special law courts for clearing bank disputes.

Proposal 32

The tenancy should be changed into contracts and its restrictions should be revised which acts as the base for borrowing.

Proposal 33

All the landing institutions should be granted the powers of SRFAESI.

Proposal 34

ARCs of having healthy capital and foreign backing should be encouraged to enter.

Proposal 35

The features highlighting the bankruptcy code in the Indian context were also outlined by the committee.

1.5 FINANCIAL INTERMEDIATION BY BANKS

Q12. Elucidate the role of banks as financial intermediaries.

Answer : *Model Pape*

The banks play a crucial role of in the economy. They act as intermediaries between the individuals having : of capital and surplus of capital. Savings, lending, investment, mediation and advice, payment and guarantees of products and services offered by banks. These activities result in two types of incomes namely, interest earr provision earnings.

The banks role are changing with the change in time. Today the banks are providing many credit and n services. The increasing competition is forcing the banks to perform the role of financial intermediaries.

The banks played the role of financial intermediatory even in the past. But traditionally, it consisted of savings and investments. But today, it brings together the people with shortages and surplus of capital together.

The business that communicates with two types of individuals and institutions in the economy is knov financial intermediatory. Therefore, the banks by interacting with two types of people are taking on the role of intermediatory.

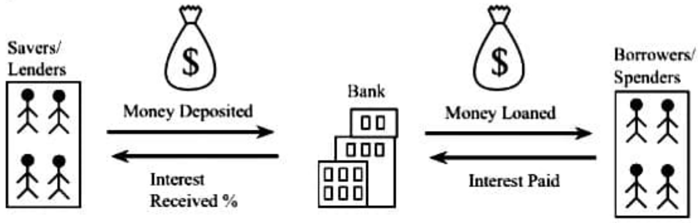

Figure: Financial Intermediation between Savers and Lenders

The banks are helping individuals and institutions having deficit, raise funds through borrowing or issui On the other hand, the individuals and institution having surplus funds are being advised on selection of the sav investments opportunitiry.

The banks are performing the following four functions of a financial intermediate.

- Transforming money by scale
- Transforming money by duration
- Transforming money by spatial location
- Acting as risk takers.

These functions clearly indicate the changing role of banks as a financial intermediary.

The availability not extensive and accurate credit assessment systems enable the banks to have an adv knowledge. This knowledge ennobles the banks to avoid risks and provide reliable information to customers. T financial intermediary service offered by the bank.

Today, the banks also meet the liquidity need. The buy and sell liquid instruments. Further, they offer less r to the borrowers and issue less-risky securities. The banks reliable information helps them invest in less risky p They issue large amount of loans and act as delegated monitors for borrowers and customers. Lastly, their in portfolios have a superior quality.

Therefore, all the above functions clearly indicate the changing role of banks as the financial intermediar

Q13. "Financial Institutions (Intermediaries) serve as a link between savers and investors". Write a note on the role of financial intermediaries along with their classification.

Answer :

Financial institutions form the second component of the IF's. Financial institutions are business organizations which deal with financial resources. They are the industrial sources of finance. It is a link between the savers and investors and helps in the credit allocation process financial institution's are necessary for the efficient functioning of the economy. By accepting the deposits from individuals and institutions, resources or funds are collected. Financial institutions then loan them to industry or trade. They take decisions regarding efficient use of scarce capital. They are involved in transactions of financial instruments. They offer financial services, functions or services of FI's include,

1. Institutionalization of personal savings by connecting the savers and investors.
2. Direct assets/securities which are issued by the corporate are converted to indirect securities. These indirect securities are more preferable than direct securities is terms of investment.
3. Through acquisition of diversified portfolios, risk is minimized because it gets transformed.
4. Savers are given custom made short term loans and buyers are given long-term loans as per the cash-flows brought about by the investment.
5. Helps in mobilization and allocation of funds through provision of loans.

The FI's are classified as banking and Non-banking institutions they include,

1. Commercial Banks/Banking Institutions

Commercial Banks are business enterprises which are involved in finances, financial instruments and provide financial services for a price which maybe in the form of interest, commission or a discount and so on. "They accept deposits of money from the public (savings), for the purpose of lending or investment (to meet working capital requirements or corporates)"-Banking regulation act 1949 banks are categorized into,

Public sector Example : SBI, Andhra Bank
Private sector Example : Milli Bank
Foreign sector Example : HSBC, HDFC.

2. Non Banking Financial Companies (NBFC's)

NBFC's are financial intermediaries whose main function is to accept deposits and deliver credit. They are responsible for channeling financial resources which maybe scarce for capital formation. They aid the banking sector in meeting the financial requirements of the corporate sector. As compared to banks NBFC's are flexible, quick, efficient and customise services as per the requirements of the clients. NBFC's provide services which may include,

- Hire purchase finance
- Equipment lease finance
- Loans
- Investments
- Factoring services
- Credit rating agencies
- Venture capital funds.
- Merchant banking organization.

3. Development (Public) Financial Institutions (DFI's / PFI's)

Development financial institutions are financial intermediaries that provide financial assistance that may be medium or long-term and aid in advancing balanced development of the country faster.

Functions

- They are development agents for various sectors of the economy.
- Help in allocating resources in areas of high priority.
- Help in promotion of development of rural areas.
- Financing housing SSI's, infrastructure etc.

DFI's consist of,

DFI's
- National / All India institutions
  - IFCI Ltd
  - ICICI Ltd
  - IDBI
  - SIDBI
  - IIBI Ltd
- Regional / state level institutions
  - SFC's
  - SIDC's
  - SII's
  - TCO's

4. Mutual Funds (MF's)

A mutual fund is a financial intermediary who pools the savings of investors and invests into a diversified portfolio of securities. Here the earnings are shared by the investors. A mutual fund can be set up in the form of a trust. It gives small investors the benefits of investing in industrial securities. MF's help investors by reducing risk, give expert professional management, tax shelter and reduce cost. E.g. UTI.

5. Insurance Companies (Organizations)

Insurance is a device by which risk is reduced or eliminated to life and property insurance is where the risk of a few people is spread out among a large number of people. It is a means of savings and investments.

Insurance organizations are responsible for investing the saving of the investors and in heir of that give an undertaking that the beneficiaries would receive a predetermined amount at a later stage or upon the happening of a certain event. Ex. LIC & GIC.

6. Foreign Private Capital (FPC)

FPC role in industrial financing in India is growing because of the congenial atmosphere regarding foreign investment has been created due to the Government policy changes.

1.6 ROLE OF COMMERCIAL BANKING AND ECONOMIC DEVELOPMENT

Q14. Elaborate the role of commercial banks in economic development of developing countries. *(Model Paper-II, Q6(b) | May/June-17, Q2(a))*

OR

Explain the role of commercial banks in economic development. *April/May-15, Q2(a)*

OR

Discuss the role of commercial banks in economic development.

Answer : *April/May-14, Q2(a)*

Commercial banks play an important role in the economy. Their role can be summarized as under,

Mobilization of Savings

Economic development depends on the available savings and investments in the economy. By mobilisation of deposits, banks collect savings from the public which in turn are lent for investment to the various sectors of the economy.

Facilitate Trade and Commerce

Commercial banks provide funds for trade and commerce which facilitates the development of economy.

Balanced Regional Development

The Government has framed a policy of balanced development in all regions of the country. Thus, banks promote lending and investments in those regions of the country which are less developed.

Providing Finance to Backward Communities and Neglected Segments of Society

Commercial banks provide loans at concessional rates to scheduled castes/tribes and weaker sections of the society, as per the guidelines of the government.

The major functions of commercial banks a

(a) Traditional Functions

- Acceptance of deposits
- Creation of credits
- Lending
- Transfer of money and other related a

(b) Ancillary Functions

The banks render many ancillary service remittance of funds or transfer of money from one another through telex, cables, telegrams etc.

They operate as an agents and trustees for r the property affairs of their customers. They also safe custody for the valuables of their customers.

(c) Incidental Functions

- Cheque Clearance and collection of n
- Safe custody of valuables
- Transfer of funds
- Merchant banking with respect to new companies
- Providing financial consultancy servi
- Portfolio management for customers
- Financing of import-export business
- Issuing letters of credit
- Doing foreign exchange business.

(d) Core Functions

Commercial banks perform two core fu namely- acceptance of deposits from public and l the public or investing in selected assets.

Q15. Discuss various challenges faced by con banks.

Answer :

Major challenges which Indian Commerci are facing today and which are likely to be more in the ensuring years in view of the irreversible p the reform and resultant verisimilitude of many mo entering the banking sector are discussed below.

1. Problem of Pressure on Profitability

The greatest challenge which PSBs are recent years arises out of pressure on their profital

With continuous expansion in number of and manpower, thrust on social and rural banking lending, maintenance of higher reserve ratios, v loans under ARDR type concessions, repayment by large industrial corporate and other borrowers their telling impact on the profitability of the bank

Further, with the introduction of prudential norms, to be effective from March end 1993 a majority of the commercial bank's balance sheets had shown huge losses. In order to improve financial health of these banks the government provided a dose of hybrid capital and in return these banks were made to sign a memorandum of understanding with RBI.

The crux of the MOU was on tuning up productivity, efficiency, cost reduction, higher recovery, Accordingly, the focus of operations of banks shifted from deposit mobilisation to services marketing, i.e., deposits have to be procured, but keeping profits in mind.

On the lending front, credit expansion entered new areas where banks hesitated to venture earlier with total thrust on maintenance of quality of lending. Further, focus of bank's operations shifted to non-fund based business with an eye on capital adequacy achievement and other ancillary business which may cross subsidize the cost of certain unremunerative services, the bank have to offer.

2. Problem of Low Productivity

Another ferocious challenge which Indian Commercial Banks are confronting is low productivity. The low productivity has been due to huge surplus manpower, absence of good work culture, and absence of employees' commitment to the organizations.

The individual excellence of staff members is mostly admired by the group dynamics of strong but unions on one hand, and the callous, ineffective, short-sighted management with their opaque impersonal personnel policies, on the other.

The management have continued to prefer not to see the problem in its proper perspective due to the fear of strong unions.

They have camouflaged the issue by diverting their attention to such apparent face saving devices like redeployment, repositioning retraining, etc. The stark reality is that the excess baggage of general cadre low productive staff members has to be removed There are various ways of minimizing the size of the staff, such as voluntary retirement scheme or golden handshake. The problem before the management at present is how to cut size of the staff and improve productivity of the bank.

3. Problem of Non-Performing Assets (NPA)

A serious threat to the survival and success of Indian banking system is uncomfortably high level of non-performing assets. In its Report on Trend and Progress of Banking in India, 1997-98, the RBI reported that gross NPAs as percentage of advances of PSBs was 16 percent as on March 31, 2000 with a colossal amount of about Rs. 52,000 crore being locked up.

This might have recently recorded further increase due to default in repayment by the industrial units affected by the two-year old recession. This is much higher than the international level of below 5%.

Spiralling non-performing assets are hurting bank's profitability and even the basic inability of the banking system by way of both non-recognition of interest income and loan loss provisioning. In view of further tightening of norms of income recognition and provisioning norms in times to come, viz., overdue PSU accounts partly or fully guaranteed by Government to be classified as NPA, accounts to be classified as NPA based on one quarter default; provisioning on standard assets, and accounts classified as substandard to be treated as doubtful after 18 months of their being NPA. Size of NPA is likely to surge unless strategic measures are taken by the bank management.

4. Problem from Customers

In view of unleashing of competitive forces and fast changing life styles and values of customers who are now better informed and more sophisticated and discerning and who have a wide choice to choose from various banking and non-banking intermediaries have become more demanding and their expectation in terms of products delivery and prices are increasing the PSB lacking in customers oriented are finding it difficult to even retain their highly valued customers what to talk of attracting the new clients particularly when the foreign banks has also the new breed of private sector banks have embarked upon aggressive marking programme aiming at niche markets.

In their efforts to the customers dint of information technology are offering special service and new and complex products. The telebanking, anywhere banking, virtual or Internet banking. ATM, Credit Cards an newly introduced interest rate swap, forward rate agreements, etc., are some of the products innovated by the new players.

A fierce war is on among the aggressive new private and foreign banks in metropolis to grab 24-square feet pieces of land to set up ATMs. The pace of installation is so high that one day the ATMs will outnumber the branches in these cities. Although the PSBs are trying to computerise their operations, the pace of progress in this direction has been slow.

The rather tardy progress in the area has been due to initial reservation of the staff unions against computerization for the lurking fear of employment cut, as also the existence of a huge number of branches in the rural areas, where suitable logistics are not available. As a result, market share of the PSBs both in deposits and lending has declined. This has already become a serious cause of concern for the PSBs regulating strategic efforts for thwarting the challenges from the new players.

5. Competition from New Banks

The commercial banks in India which enjoyed monopoly position unit recently are facing perilous challenges particularly on quality, cost and flexibility fronts from the newly emerging players who by dint of their invigorating ambience and work culture supported by pragmatic leadership, committed courteous, affable and trained staff and modern ultra gadgets are offering excellent customer services and making inroads in the business centers.

6. Competition from Global Majors

Globalization and integration of Indian Financial market with world and the consequent entry of foreign players in domestic market has infused, in its wake, brutal competitive pressures on the Indian commercial banks.

Foreign player endowed with robust capital adequacy, high quality assets, worldwide connectivity. Benefits of economies of scale and stupendous risk management skills are posing serious threats to the existing business of the Indian banks. In order to compete successfully with the new entrant Indian banks need to posses matching financial muscle, a fair competition is possible only along the equals. Average size of an Indian bank is niggardly low in comparison to a foreign bank. The question before the major Indian commercial banks, therefore, is how to acquire competitive size.

7. Competition from Disintermediation

Indian commercial banks are facing competitive onslaught not only with the system but also from other quarters. The threat of financial disintermediation has already started looming large.

During the year 1997 up to August 2000, Indian corporate are reported to have mobilized funds of Rs. 2,451 corers through commercial paper as compared to Rs. 182 crores during the corresponding period last year.

This threat is going to be more deeper in future in view of increased role of market forces. With increasing integration of markets and opening of more avenues to meet financial needs of corporate, capital will flow more freely across Indian borders, good creditworthy borrowers would be able to source cheap finance aborad as well as in domestic capital markets.

8. Problem of Managing Duality of Ownership

Managing duality of ownership is a peculiar problem which the PSBs have to encounter because of the participation of private shareholders in their share capital.

A public sector bank to survive and grow successfully is expected to be operated according to the expectations of one of its principal shareholders. In the changed scenario, there would be two major groups of shareholders viz., the government of India and RBI on the one hand and the private shareholders on the other, since the expectations of these two categories of owners are not necessarily identical, the bankers will have to manage conflicting interests.

9. Problem of Managing Customers of Diverse Strata

In a country as vast as India and wide disparities in standards and ways of living in its rural, semi-urban and metropolitan areas, banking services have been designed and delivered in keeping with the different levels of economic property enjoyed by the population in each of these areas and their relative needs.

Banking needs of a vast majority of the country men living in rural and semi-urban regions are extremely simple and for them benefits of modern day technology driven banking will be a far cry for some time to come. In these areas it is availability of service and its cost and simplicity and not the high quality that matters most.

10. Challenge of Qualitative Change in Banking Paradigm

The greatest challenge which Indian bankers are facing is to bring about change in the mind sets and attitude of the employed and inculcate work culture.

Bank employees in India, as noted earlier, are highly cynical and less motivated with decreasing loyalty towards their work life.

They are not very much concerned with their productivity and lack cost consciousness. Strong and militant trade unions resisting any organizational change and archaic approach of managing have also been the barriers to bank development.

1.7 RBI

Q16. Explain how RBI has been established under Reserve Bank of India Act, 1934. State the objectives behind the establishment of RBI.

Answer :

RBI Act, 1934

RBI is a monetary authority and central bank of the country. It has the power to manage, develop and regulate the financial system.

The RBI Act, 1934 is a primary legislation for regulating banking services in India. The Reserve Bank of India is given the authority to control all banks from their establishment till their windup. The Act specifies that the direct discounts should be given to customers during special occasions for regulating credit in trade, agriculture and industry.

Establishment of RBI

The need for Central Bank of India arised when the government was not able to control the currency and credit system to a satisfactory level. The Hilton Young Commission recommended for the establishment of Central Bank in India. However, the proposal was cancelled in 1927. Later on, in the year 1931, the Central Banking Enquiry Committee reviewed the need of Central Bank in India. This proposal was again reviewed by legislative assembly and realized the importance of Central Bank.

Finally, with the recommendation of Legislative Assembly, RBI came into existence on 1st April, 1935 under the Reserve Bank of India Act, 1934. RBI is a financial institution of Indian Financial System. It plays a vital role in bank management as it is responsible for the task of control, supervision, promotion, development and planning the activities of bank management.

RBI as a corporate body have perpetual succession and a common seal with a capital of ₹ 5 crores completely owned by the Indian government. RBI has occupied a unique place in the banking and financial sector. It act as a banker to the government as well as for all the banks and is responsible for the banking, non-banking and financial institutions activities in the country.

Objectives of RBI

According to the preamble of Reserve Bank of India Act, 1934, the objective of RBI is, "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage".

The other objectives of RBI are,

(i) To regulate financial policy and develop banking facilities throughout the country.

(ii) To be away from political influence and be in successful operation for maintaining financial stability and credit.

(iii) To act as the note-issuing authority, bankers bank and banker to government.

(iv) To promote the growth of the economy within the framework of the general economic policy of the government, consistent with the need for maintenance of price stability.

(v) To assist the planned process of development of the Indian economy.

(vi) To create or help to create the machinery needed for financing developmental activities all over the country.

(vii) To ensure the flows of finance available in the directions intended.

(viii) To fill the gaps in the financial infrastructure.

Q17. Explain the functions of RBI.

Answer :

The Reserve Bank of India Act of 1934 entrust all the important functions of a central bank to the Reserve Bank of India. The following points explain the functions of RBI,

1. Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate issue department which is entrusted with the issue of currency notes. The assets and liabilities of the issue department are kept separate from those of the banking department.

2. Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and advisor. The Reserve Bank is an agent of central government and of all state governments in India except the government prevailing in Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations.

3. Banker's Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act 1949, every scheduled bank is required to maintain a cash balance equivalent to 5% of its demand liabilities and 2 percent of its time liabilities in RBI. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 percent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

4. Controller of Credit

The Reserve bank of India is the controller of credit i.e., it has the power to influence the volume of credit created by banks in India. It can do so through changing the bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular Bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. The Reserve Bank of India is armed with many more powers to control the Indian money market.

5. Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. After India became a member of the international Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the IMF. Besides maintaining the rate of exchange of the rupee, the Reserve Bank acts as the custodian of India's reserve of international currencies.

6. Supervisory Functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions. The Reserve Bank Act, 1934 and the Banking Regulation Act, 1949 have given the RBI wide powers to supervise and control over commercial and cooperative banks relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working amalgamation, reconstruction and liquidation.

7. Promotional Functions

With economic growth assuming a new urgency since independence, the scope of the Reserve Bank functions has steadily widened. The Bank now performs a variety of developmental and promotional functions. The reserve bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas and establish and promote new specialized financing agencies.

8. Classification of RBIs Functions

The monetary functions, also known as the central banking functions of the RBI are related to control and regulation of money and credit i.e., issue of currency, control of bank credit control of foreign exchange operations, banker to the Government and to the money market. Monetary functions of the RBI are significant as they control and regulate the volume of money and credit in the country.

Q18. What kind of role is played by RBI in controlling credit/money supply?

Answer :

The Reserve Bank of India (RBI) plays a significant role in monetary management and credit control in India. The basic function of RBI is to prepare and administer the monetory policies and monitor the credit flow in the Indian economy in order to develop the interval price stability.

Monetory policy refers to, "the use of various instruments, under the control of the central bank (RBI) in order to have an effect to the total demand for goods and services by controlling, the supply of money and credit in the economy".

Role of RBI in Controlling Credit/Money Supply

In order to control the rapid expansion of bank credit, RBI adopted a strict monetary policy which reduced the inflation by increasing the interest rates on money supply. This discourages the public to invest in various projects, which in turn reduced the purchasing power of the people.

To control the high inflationary situations after 1973-74, RBI used quantitative control which is commonly known as general credit controls and includes bank rate policy, open market operations and CRR. RBI by using these controls increased the bank rates from 10% in 1981-91 to 12% in October 1991. Thus, with an increase in interest rates the inflation is controlled after 1974.

Inflation also increases, if the interest rates are increased beyond the limits (i.e., if the interest rates are increased substantially, severe problems of liquidity arises which leads to shortages in supply resulting high inflation by increase in prices because of increased demand).

To avoid the problems occurred due to the fluctuations in interest rates, RBI fixed all the bank rates and other market securities interest rates for controlling the credit supply. Since 1995-96, there was a rapid growth in liquidity, which had adversely affected the investment and production. To control this situation, RBI raised the Cash Reserve Ratio (CRR) to 15% of the net demand, which influenced the amount of cash associated with the commercial banking system. In 1995-96, again RBI had made an attempt to reduce the CRR to 8% in 1997 and finally to 5% in 2002. RBI uses Statutory Liquidity Ratio (SLR) and CRR as the inflation regulatory instrument for effective handling of inflation mechanism.

Narasimham committee submitted a report in November 1991. This report suggested that high CRR had an adverse affects on the profitability of banks. When RBI had realised that CRR should not be used as a credit control weapon, it reduced the levels of CRR so as to bring down to the international levels. By reducing CRR, large reserves can be built with the banks which enable them to expand their credit facility. As, the Indian economy had witnessed the economic recession for a period of time, reduction of CRR and expansion of bank credit were found to be beneficial in stimulating the growth of Indian economy. In the coming years, this ratio could be reduced to just 3% by the measures of RBI.

The preamble of the RBI Act, 1934 states that RBI has the power to regulate the issue of the bank notes and maintain the reserves for establishing monetary stability of India, which helps the Indian government to take the advantage from the operations of the currency and the credit system.

Interest rates and investments are mostly affected by the supply of money. Various theories have been propounded by the economists in relation to the development and the creation of money. When the supply of money increases, the rate at which it is issued to the general public decreases i.e., with an increase in the supply of money, the interest rate decreases. As soon as the considerable amount of money gets deposited with the bank, it will initiate the issues of loans to the general public.

With an increase in the supply of money, the investments made by the general public increases as they can avail the benefits of loans at low rate of interest. Higher investment is followed by the increased employment opportunities thereby, increase the purchasing power of individuals. High purchasing power of individual led to the development of demand which causes the inflation to rise.

There exists a cyclical relation between inflation, interest rates and money supply. Inflation is greatly influenced by both interest rates and the supply of money.

Q19. Explain different methods/instruments used by RBI in controlling credit.

Answer :

The reserve bank of India makes use of different instruments/methods for achieving the objectives of monetory policy. The choice of the instrument depends on the features of the economy and several other problems. The instruments/methods are broadly divided into two types,

I. Quantitative instruments

II. Qualitative instruments.

I. Quantitative Instruments

The quantitative instruments are also known as general instruments which directly or indirectly influences the lending and credit creating ability of the commercial banks. These include,

1. Bank Rate/Discount Rate

Bank rate is the interest rate at which the RBI purchases or rediscounts, bills of exchange, securities or commercial papers. It act as leading indicator of RBI monetary policy. When the RBI is in need of more liquidity in the market, it reduces the bank rate, thus encouraging the banks to lend more loans. On the other hand, when there is abundant supply of cash in the economy, the RBI increases the bank rate, thus forcing the banks to stop offering the loans.

Generally, the RBI makes use of the bank rate as one of the tool to control inflation.

2. Open Market Operations (OMOs)

OMOs are basically carried out by RBI and it includes timely sale and purchase of government securities or bonds in the open market. These securities are of different yield rates, denominations and different maturity period.

OMO's denote both the debt transaction and also the quantitative credit control. As the RBI sells these securities to the public, the money gets transferred from the public and dealers to the RBI. As and when the public and dealers withdraws cash from the banks, the cash reserve of the banks will reduce, further reducing the credit supply. This has double impact. Firstly, it reduces the aggregate demand for goods/services as there is no money to buy and secondly, it would increase the interest rate.

3. Cash Reserve Ratio (CRR)

CRR or legal reserve requirement is a non interest bearing funds (cash) which all the commercial banks should deposit with the RBI. According to the RBI Act, C.R.R lies between 3 to 15 percent of demand and time liabilities. These funds are generally used by the RBI for purchasing the foreign exchanges providing loans to banks.

The CRR is used as an effective tool to control money and credit supply in the economy. Under restrictive monetory policy, the CRR would be increased, public would transfer a major part of money from the active deposits to passive reserves of the RBI. This leads to shortage of loanable funds in the banks.

4. Statutory Liquidity Ratio (SLR)

SLR is a specific percentage of cash deposits, which every bank needs to maintain (with itself) to meet the day-to-day withdrawal requirements from its customers.

Under a liberal monetary policy, the RBI may lower the SLR, thus leaving more cash with banks for the purpose of lending. On the other hand, under a restrictive monetory policy, the SLR may be raised.

II. Qualitative Instruments

The RBI uses these instruments, to change the direction of money/credit so that they effect the distribution instead of effecting the quantum of money in the economy. Generally, RBI makes use of these methods to increase flow of funds to priority sectors like agriculture, small scale industries etc. The different qualitative instruments of credit control are as follows,

(a) Differential Interest Rates

Generally, banks borrow funds from RBI and lend them to general public. The RBI may charge a lower bank rate to banks which it lends according to the priority to different sectors like agriculture, exports etc., low bank rate is offered for priority sector and higher bank rate for non-priority sector. Thus, it encourages banks to lend more funds to priority sector.

(b) Moral Suasion

In financial terms, moral suasion refers to the process of RBI giving advice to banks and other financial houses, with respect to lending policies and other functions. Generally, the RBI advice banks about the level of credit which is to be granted by banks during a specific period of time.

(c) Restriction on Bill Discounting

This is another important qualitative tool of credit control used by the RBI. Under this, the RBI may disallow restricted bill discounting against price restive products which influences the money supply in the system.

1.8 BANKER - CUSTOMER RELATIONSHIP

Q20. Who is the customer of a bank? Discuss its features and eligibility criteria for becoming the customer of a bank.

Answer :

Customer of Bank

Any entity or individual carrying out transactions through a bank is regarded as its customer. The term customer of a bank does not have any definition in terms of law.

Features of Customer

The following are the characteristics/features of a customer,

1. The customer maintains a deposit account with the bank.
2. The duration of holding the account is unimportant or irrelevant.
3. The bank account showing a debit balance on credit balance is irrelevant or unimportant.
4. The relationship which exists between the banker and customer also exists between the banks which maintain accounts or clear cheques among each other.
5. The visitor visiting a bank for clearance of cheque or purchase of draft etc will not be termed as a customer.
6. A customer of one branch cannot become a customer of other branch of a same bank without maintaining an account in that branch.
7. A depositor's agreement to open an account with the bank makes him a customer of the bank.

In the current banking environment, the nature of dealings, or status of a person plays a vital role in determining a customer. The nature of dealings should be of 'banking business'. If an individual or entity does not deal with core banking functions but avails other services then he will not be considered as a customer.

Therefore, debtor and creditor relationship is the basic relationship existing among a banker and customer. The banker also acts as an agent or truster for their customers.

Eligibility Criteria for becoming a Customer

The banks role as financial intermediary forces them to accept public savings as deposits. But legally valid contracts can be entered by the banks with specific sections of the society.

Hence, the deposit accounts can be opened by a,

(a) Person or entity who is capable of entering into a valid contract.

(b) Those individuals who follow the rules and regulations of the banks at the time of entering into a contract.

(c) Those individuals who accept the terms and conditions of the banks.

The banks have the right to reject the application for opening the deposit accounts.

However, there are some special classes of bank customers. They are as follows,

The Indian Contract Act, 1872 restricts the minor from entering into a contract and considers the contract, entered by the minor as void. But the contract for supplying the goods and services which are required for a minor to survive is considered as valid contract. Hence, banks need to be very cautious at the time of opening and operating a minor's account. The loan granted by the bank to the minor cannot be recovered. So, the bank should ensure that the account does not get into overdraft position. The bank must also be cautious if the negotiable instrument is signed by the minor. Section 26 of Negotiable Instrument Act permits a minor to issue a cheque or negotiate a bill of exchange without being sued.

- A husband is held responsible for a married woman's actions after entering into a valid contract if the loan is taken under his supervision by the wife or is taken for meeting the necessities of his wife. The bankers must ensure that the woman possesses the assets of her own, before entering into a contract with her.
- Only after the identification of pardanashin woman, the banker must enter into a contract with her.
- Only after the identification of pardanashin woman the banker must enter into a contract with her.
- The illiterate persons thumb impressions and photographs should be taken as identification proofs by the bank.
- The accounts should not be opened in the name of the persons of an unsound mind.
- Sections 3 of the Indian Trusts Act, 1882, defines trust as an obligation annexed to the ownership of property and arising out of confidence reposed in and accepted by the owner for the benefit of another. Therefore, banks must be cautious while opening accounts in the name of the trustees.
- Precautions should also be taken by bank while opening and operating accounts of a joint Hindu family.

Q21. Write in detail about the bank-customer relationship.

Answer :

The relationship between a bank and customer comes into existence once an account has been opened with the bank and the fund have been deposited. The following are the types of relationships exist between a banker and a customer. They are,

1. **Creditor-debtor Relationship**

The banker-customer relationship was traditionally known as a debtor-creditor relationship. The bank becomes a debtor by accepting the customer's deposits and a creditor by lending money to its customer. However, this relationship includes other contractual incidents while are implied by the courts.

2. **Agency Relationship**

When a customer draws a cheque on his or her account, then an agency relationship comes into existence between the customer and the bank. The customer orders the bank to pay the amount which is specified on the cheque to its holder. The bank is therefore the agent of the customer and is obliged to pay the amount. In the same way, when the customer deposits the cheque into the bank, the bank is obliged to collect its payment from the specified bank.

3. **Contractual Relationship**

A set of contractual rights and duties exists when the relationship between banker and customer is built. These rights and duties vary according to the nature of the transactions.

4. **Principal and Agent Relationship**

This relationship exists when the customer gives instructions to the bank and the bank acts as per the instructions and is not permitted to earn or make secret profits. The customer should be informed about the commissions which are payable.

5. **Bailor and Bailee**

These terms are related to bailment contract. The bailor hands over the property to bailee for a certain purpose and the property is returned to the bailor after the purpose has been completed. Similarly, in case of bank, the securities or deeds deposited by the customer for safe custody is referred to as bailment. In this case the bank is the bailer and the customer a bailor.

6. **Mortgagor and Mortgagee Relationship**

The customer mortgages his property for acquiring loan or overdraft from the bank. Therefore, the customer becomes a mortgagor and the bank is a mortgagee. Each party hold certain rights and duties specified by law. The customers usually mortgage stocks, shares and land or house.

7. **Trustee/Constructive Trustee**

This is a special relationship existing between the banker and the customer. This relationship comes into existence when a bank uses the funds in the bank accounts for a certain purpose even after being aware of the fact that they are not to be used.

1.9 FUNCTIONS OF A BANK

Q22. Define bank. State the various functions of a bank.

Answer :

Meaning of Bank

The term 'bank' is derived from a Greek and Italian words 'Banque' and 'Banco', which means 'a bench' which is used by the money-lenders to display their coins and making business transaction. However, in the modern world, bank is referred as the financial institution which accepts deposits, lend and creates money from financial sources.

Definitions of Bank

"A bank is a person or corporation which holds itself out to receive from the public deposits payable on demand by cheque".

– *Walter Leaf*

"A banking company is defined as one which transacts the business of banking which means accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawals by cheque, draft, order or otherwise".

– *The Banking Regulation Act, 1949.*

A bank is "A manufacture of credit and a machine for facilitating exchange".

– *Horace White*

Functions of a Bank

Following are the functions of a bank,

1. Accepting deposits from customers.
2. Safeguarding deposits of customers.
3. Repaying deposited money on required or order or otherwise.
4. Paying interest on deposits.
5. Providing loans and advances to the needy individuals, organisations or companies.
6. Dealing in securities market.
7. Transferring deposits from one bank to another bank and from one country to another country.
8. Providing Debit cards, Credit cards, ATM services, Net banking services, Mobile Banking services and so on to the customers.
9. Working as an agent for its customers.

1.10 BANKING SECTOR AND ORGANIZATION OF BANKS

Q23. Discuss in detail about the banking sector and organization of banks in India.

Answer :

For answer refer Unit-I, Page No. 1.2, Q.No. 1.

1.11 DIFFERENT TYPES OF ACCOUNTS

Q24. Explain briefly about different types of accounts prepared in banks.

Answer : *Model Paper-III, Q6(a)*

A banker should be very careful while opening an account and must take all the necessary steps for satisfying the customer with whom the contract is being made and with whom banker-customer relationship is to maintained. After completely being satisfying with the identity of a customer and formalities the bank must open an account. Bank usually deals with different types of customers, as follows,

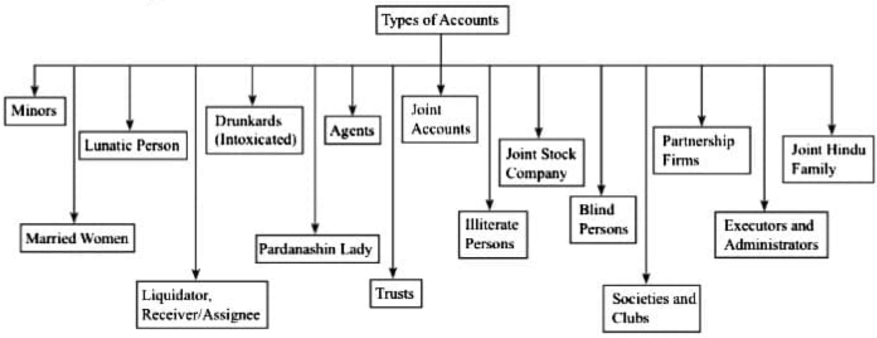

Figure: Different Types of Accounts

(a) Minors

According to Indian Law, a person below 18 years of age is considered as minor and any contract with minor is treated as invalidation and void. The following conditions need to be satisfied for opening an account of a minor:

(i) A minor who has completed 10 years of age or more is given permission by the bank for opening a savings Bank Account.

(ii) The Banks suggests to open the account in guardian's name or a joint account in the name of both minor and his guardian.

(iii) Proper introduction of minor is necessary and date of birth of minor needs to be properly written or filled up in the form.

(iv) Bank must decide the limits of maximum deposits accepted in such accounts.

(b) Lunatic Person

A Lunatic person is are the one who is mentally disturbed and is of an unsound mind. Sec.12 of the Indian Contract Act, 1872 states that persons with unsound mind are not capable of entering into a valid contract. Banker must not open an account in the name of lunatic person as he is not a competent party. As soon as banker becomes aware of customer's insanity, it must stop the transaction of the account and verify the truth about customer.

(c) Drunkards (Intoxicated)

A drunkard person is the one who takes alcohol and becomes uncontrollable when he drinks alcohol. But a banker cannot be restricted from opening an account in the name of drunkard. In case, if the customer is a regular drunkard and is addicted to drinking then the banker must force the drunkard to bring witness to countersign when payment is made against a cheque.

(d) Agents

A bank might open an account in the name of agent who is act's on behalf of another person. The account is treated as a personal account of the agent and the banker cannot interfere in his dealings. If a person is given authority to the principal then banker must assure, whether the agent is really authorised to perform the acts which he claims to do so.

(e) Joint Accounts

In case of opening a joint account, the banker must collect all the necessary information from members in writing like who can withdraw cheque's and in case of death of any party are to be paid to the survivors or what must be done and so on. If instructions are not provided then the complete balance of the account is given to the survivor or the survivors of a joint account.

(f) Joint Stock Company

As joint stock company is explained as an artificial person which is invisible, intangible and exist's in the eyes of law. Before opening an account in the name of the company, the banker must verify the following,

Memorandum of Association, Article of Association, Certificate of Incorporation, Certificate of Commencement of Business, Application form and copy of the boards resolution and a written mandate.

(g) Partnership Firms

According to the Indian Partnership Act, 1932, partnership is defined as "the relation between persons who have agreed to share the profits of the business, carried by all or any of them acting for all". The Bankers should verify the following before opening an account in the name of the partnership firm.

Completely filled in application form with signatures of all partners of the firm, partnership deed, a written mandate, banker must assure that the funds of the firm must not be credited to the personal accounts of the partners and before giving the overdraft facility, banker should verify the partnership deed and borrowing powers of the partners.

(h) Joint Hindu Family

Joint Hindu family refers to an undivided Hindu family which includes all the male members of a family who carries out the business. The following are the precautions which a banker must take before opening an account,

1. Banker must collect complete information about joint Hindu family i.e. the names of the major and minor coparcener's.
2. The account could be opened by the banker either in the name of the Karta or in the name of family business.
3. Both Karta and Major coparcener's must duly sign the documents of the bank.
4. The Karta and the major legitimate coparcener's must carry out operations of the account.

(i) Married Women

Under Sec. 14 of Hindu Succession Act, states that property of a hindu female is her authoritarian property and is a separate legal entity. She can acquire loans against her own property.

(j) Pardanashin Lady

As the identity of the pardanashin lady cannot be acertained, accounts related to her demoralized. Contract with a pardanashin lady is not free from defects and also holds presumption of undue influence.

(k) Illiterate Persons

The accounts of an illiterate person are to be made on ledger-folio/AOE. The illiterate person should carry an independent witness for introduction and explanation of rules. Identification marks of illiterate person are to be taken and for every three years photograph of the person need to be changed. Payment to illiterate person is made directly through the cashier.

(l) Blind Person

The accounts of a blind person are to be made on ledger folio/AOE. He should carry an independent witness for introduction and explanation of rules. The receipts/ payments of the person is taken by an independent witness on behalf of him. Identification marks of the blind person are taken and for every three years photograph of the person is to be changed. Finally it is advised that it is better to have a joint account for blind persons.

(m) Executors and Administrators

The executor is the person named in the will of the deceased person and account to be opened on production as mentioned in the will. Administrator is the person who is appointed by the court and should produce letter of administration. Both executors and administrator can stop the payment with the existence of any one of them. But withdrawal is possible only when both join together. In case of death of an executor, the powers are transferred to the surveying executor.

(n) Liquidator and Receiver/Assignee

Liquidator is appointed when the company is in liquidations and receiver/assignee manages the property of an insolvent person. During the opening of an account the status of the liquidator and receiver/assignee is to be mentioned in the title of the account. Both liquidator and receiver/assignee cannot acquire the loans and if they do so it will not be granted.

(o) Trusts

The trust account examines the trust-deed to allow loans only after the assurance from the trustee. The trustee personal accounts are investigated incase of transfer of funds from trust account to personal account. Trustee must act jointly as there is no authority to authorize. Incase of insolvency of trustee it does not affect the trust property. Incase of death of one trustee, property is transferred to other trustees where the court order is necessary to proceed.

(p) Societies and Clubs

Bank can open accounts of unregistered clubs, institutions, societies, association, schools etc by providing registration certificate of the account holder.

1.12 VARIOUS SERVICES OFFERED BY BANKS

Q25. Explain the various services offered by banks. *April/May-15, Q2(b)*

OR

Explain the services provided by banks to customers.

Answer : *May/June-13, Q2(a)*

The banks have been offering various services to its customer. These services can be basically divided into two categories. They are,

(a) Traditional services

(b) Modern services.

(a) Traditional Services

These services include the following,

1. Carrying Out Currency Exchanges

Currency exchange is the first ever service offered by the banks. The banks accept on currency for other currency and charge a minimum fee for this service. This service is very useful for foreign travellers as it grants access to local currency. Today foreign currency exchange is carried out by large firms providing financial services.

2. Discounting Commercial Notes and Making Business Loans

The discounting of commercial notes was carried out by bankers and loans were granted to local merchants against their debts for raising quick cash. Today these services are provided by banks, financial companies, insurance firms and other financial service providers.

3. Offering Savings Deposits

The banks ensured raising of additional funds through savings deposits. The funds were to generate interest when left with the financial institutions for a specific or predetermined time period.

4. Safe Keeping of Valuables and Certification of Values

The banks also provided the service of holding gold and other valuables of customers and ensuring their safety. These valuables were kept in the secure vaults and the value of these valuables were certified by the banks.

5. Supporting Government Activities with Credit

The banks capability of mobilizing funds of large amount was recognized during the early years of industrial revolution by the European governments. The banks were to purchase a specific amount of government bonds from the deposits received. This continued during the revolutionary war and in 1781, under the rule of continental congress, the bank of North America funded towards making United States sovereign nations. Later the national banks were to purchase government funds for funding the war according to the terms of the government.

6. Offering Checking Accounts (Demand Deposits)

The banks also started providing the demand deposit services to the customers during the industrial revolution. Under this service the depositor was permitted to issue drafts for the goods and services purchased or acquired and the banks were to honor these drafts immediately. This is one of the important services even today as it ensures efficient payments and makes transactions easier, faster and safer. Today these services have been extended to the internet and electronically operated 'smart cards'.

7. Offering Trust Services

Bankers have been successful in managing the financial affairs and properties of individuals for a small amount of fee. Therefore trust services refer to the property management function provided by banks.

(b) Modern Services

Today, the services provided by the banks have increased. In addition to the traditional services the banks also offer the following modern service,

1. Granting Consumer Loans

Earlier banks completely relied on consumer deposits for funding huge corporate funds. But today the focus has been diverted towards the consumers. In the past it was believed that such loans may be unprofitable. But since the shift of financial services providers towards granting of consumer loans, banks have also began providing this service.

2. Financial Advising

The banks today provide various financial advisory services to their customers. Earlier such services were not provided by the banks. These advises include tax return plans and financial plans for marketing of consumer businesses.

3. Managing Cash

Banks have recently identified the management of cash as one of crucial services, for the consumer. The banks handle all the services of cash collection and payment on behalf of their customers. However, these services are provided by banks to businesses, similar services are being offered by financial institution to their customers.

4. Offering Equipment Leasing

The banks also offer the service of equipment leasing to their customers. The bank purchases the equipment and rents it to the customer on a rent through a lease agreement.

5. Making Venture Capital Loans

Today banks also provide start-up costs for new companies. To overcome their risk the funds are provided through venture capital firms that raise money from investors for financing new business and hoping to yield profit after being sold or becoming public.

6. Selling Insurance Policies

The bankers have also started selling insurance policies to their customers and guarantee repayment upon death or disability of the borrower. This service was abolished in U.S banks in 1930s, as a result of great depression. But today it is one of the key services provided by banks. The banks offer a space in the lobby to insurance companies, on rent, for selling their policies.

7. Selling Retirement Plans

Banks also handle the retirement plans that are offered by businesses to their employees. The retirement plans are sold by banks to individuals and their deposits are kept till funds are required for income after retirement.

Q26. "Banks also offer various brokerage and investment services". Elucidate.

Answer :

Offering security brokerage services and investment services is one of the largest banking service target. The security brokerage and security investment services were abandoned in the United States as the result of Glass Steagall Act of 1933 which separated the commercial and investment banks. The introduction of Gramm-leach-Bliley act in the end of 1999 allowed the banks to offer security brokerage and investment services.

The service in which the banks buy and sell securities on the order of their customers is referred as security brokerage service. The banks also market new securities, for corporations and other institutions, to raise funds which known as investment banking service.

Some of the brokerage and investment services which are offered by the banks are as follows,

1. Offering Mutual Funds and Annuities

The demand for investment products has increased rapidly by the customers. The mutual funds and annuities are the two most important investments products. There products involve more risk than the bank deposits but yield higher returns.

The annuities are long-term savings plans which ensures the payment of income to its holder on a specified future date while mutual funds are professionally managed investment programs which involves the acquisition of stocks, bonds and other assets that meet the desired objectives. The banks have assigned special subsidiary organizations for marketing these services, which in turn drives other key competitors to expand their services and offer fixed and variable annuity plans for their customers.

2. Offering Merchant Banking Services

The banks are also offering merchant banking services to large corporations. Purchasing the corporate stock on a temporary basis and funding new business or expanding the business are some of the merchant banking services offered by banks. Therefore, the merchant banker assumes the risk of decline in stock value and becomes the temporary stock holder. Practically, merchant banker identifies the merger targets and provides the customers with strategic marketing advice.

3. Offering Risk Management and Hedging Services

The banking sector is passing through various fundamental changes. Today banks provide financial tools against risk exposures and charge large amount of fee. Presently, banks act as the largest dominator of risk-hedging by acting as dealers for ensuring/managing risk protection for its customers or by selling bank's risk protection contracts to its customers. This has resulted in the growth of risk-hedging tools such as swaps, options and futures contracts.

Q27. What are the various services offered by banks? What are the items observed in banks balance sheet?

Answer : *May/June-16, Q2(a)*

Various Services Offered by Banks

For answer refer Unit-I, Page No. 1.27, Q.No. 25.

Items Observed in Banks Balance Sheet

The banks of India prepare financial statements as per third schedule of section 29 of the banking regulation Act. Therefore, their statements tend to be similarly structured. The balance sheets include a total of 12 schedules. The following is the sample of Indian Bank's typical balance sheet.

Schedule	Liabilities	Schedule	Assets
01	Capital	06	Cash and balances with the RBI.
02	Reserves and Surplns	07	Balances with banks and money at call and short notices.
03	Deposits	08	Investments.
04	Borrowings	09	Advances.
05	Other liabilities and provisions	10	Fixed assets.
11	Other assets.	12	Contingment liabilities

I. Bank Liabilities

The following are included under this category.

(i) Capital

The authorized, subscribed and paid-up capital of the bank are written under this head. The capital should be maintained by both private and foreign banks in accordance with the RBI guidelines.

(ii) Reserves and Surplus

This head includes the following components,

- **Statutory Reserve**

  According to section 17(1) of the banking regulation Act 1949, every bank should create a reserve fund comprising of 20 percent of the profit balance.

- **Capital Reserves**

  Capital reserve account includes the excess amount of depreciation on investments or profit on sale of fixed assets on investments.

- **Share Premium**

  The premium on issue of share capital is included under this heading.

- **Revenue and Other Revenues**

  All other reserves not included in any of the above categories is included under this category.

- **Balance in Profit and Loss Account**

  The balance amount of profit after adjustments is included under this head.

(iii) Deposits

The following deposits are included in the balance sheet of banks operation within India.

- **Demand Deposits**

  The current accounts and term deposits due but not paid are included in this category. No interest is paid by bank on such balances.

- **Savings Deposits**

  Such deposits are created for the purpose of household savings. Some incorporated bodies are prohibited from operating saving accounts by the RBI.

- **Term Deposits**

  The deposits bearing a maturing period of 15 days to 10 years are accepted by the banks. In special cases or cases involving minor the term of 10 years is accepted. Fixed deposits, recurring deposits, reinvestment deposits, cash certificates are some of the forms of term deposits.

(iv) Borrowings

The balance sheet of banks operating within India includes two types of borrowing. They are borrowings within India and borrowings from outside India.

(v) Other Liabilities and Provisions

This category involves the following,

- **Bills Payable**

  The liabilities resulting from fee based services, such as demand drafts, banker's cheques and traveller's cheques are the constituents of floating liabilities of banks.

- **Inter-office Adjustments**

  It refers to the net credit balance and is included in the liabilities side.

- **Interest Accused**

  The interest on deposits and borrowings that are due for payment are included under this head.

- **Others**

  Provision for income tax, bad debts and depreciation on securities are included under this head. It also includes all the other liabilities which do not fall under any of the above categories.

II. Bank Assets

The assets side of the Indian balance sheets include the following,

(i) Cash and Balances with the RBI

It includes all the cash assets of the bank.

- Cash invovles cash in hand and cash at bank whether in foreign currency or in an overseas bank branch.
- To meet the Cash Reserve Requirements (CCR) a balance is maintained by with the RBI.

(ii) Balances with Banks and Money at Call and Short Notice

The balances held by bank at different banks are disclosed under this head.

(iii) Investments

Investments generate large incomes to banks during the period of soft interest rates. The RBI divided investment into six groups to reduce the risk factor. They are,

- Government securities.
- Approved securities.
- Shares.
- Debentures and bonds
- Subsidiaries or joint ventures.
- Other investments.

- **Loans and Advances**

This heading includes the loans or advances granted by the banks. The loan granted is commonly divided into three categories. They are,

- Nature of credit farility granted.
- Securities arrangements.
- Sector.

(iv) Fixed Assets

The fixed assets are divided into the following categories.

- Premites.
- Other fixed assets.
- Assets on lease.

The value of assets after the adjustments have been made are included under this head.

(v) Other Assets

This includes the following categories,

- **Interst Accured**

  Interest earned but not received is included under this head.

- **Inter Office Adjustments**

  This inter office adjustments showing debit balance is shown under this head.

- Advance tax paid.
- Stationary and stamps.
- Non-banking assets taken over as satisfaction for claims.
- **Others**

  It includes the accumulated losses.

(vi) Contingent Liabilities

It includes the following heads,

- Claims made against banks but not confirmed as debts.
- Liability for partly paid investments.
- Guarantees given for outside constituents.
- Acceptances, endorsements and other obligations.
- Currency swaps.
- Interest rote swaps, currency options and interest rate future.
- Other items holding banks contingently liable.

1.13 SOURCES OF RISKS IN BANKS

Q28. Explain briefly about the various types of risks associated with banking transactions.

Answer :

For answer refer Unit-I, Page Nos. 1.31 to 1.35, Q.Nos. 29, 30, 31 and 32.

1.13.1 Interest Rate Risk

Q29. Write in detail about the various methods of interest rate risk management.

Answer :

To hedge the interest rate, the banking system is complied by deregulation of interest rates and operational flexibility in pricing of assets and liabilities of the banks. The interest rate risk is the risk wherein the market rates affect the bank's financial condition. The changes in interest rates imposes vast impact on the functioning of the banks. The changes in interest rates have an immediate impact on the earnings of the banks.

Variation in market rates affects off-balance sheet position and the changing interest rates on banks MVE (Market Value of Equity). The banks and financial institutions measure ALM interest rate risk on the basis of following reasons,

(i) For establishing the amount of economic capital.

(ii) For reducing the risks.

The banks uses the following approaches for measuring ALM interest rate risk.

1. Gap Analysis

Gap analysis is found to be one of the most suitable methods for measuring interest rate risk. By using this method, maturity gap is determined for a given period of time. While calculating maturity gap, it takes into consideration both fixed and floating assets and liabilities that tends to mature in the same period.

The bank which has a positive gap will see the interest income rise if market interest rate rises as more assets than liabilities will contribute this increase. The bank will be benefited by falling rates and will face loss by rising rates with a negative gap.

A simple maturity gap measure, calculates a sequence of periodic maturity gaps, like series of three months gaps for five years. The maturity gap method has the advantage of a greater accuracy.

For estimating how net interest income will react after reducing the measure of interest rate exposure by one number, the concept of duration was developed.

When discounted cash flows are used as weights, the duration analysis provides the weighted average time for repricing. The difference between duration of assets and liabilities is a "duration gap". The bank gets more sensitivity due to the changes in the market rates because of the larger duration gap.

Duration gap is stated to be accurate when the term structure of interest rates shifts in parallel are known in advance.

2. Rate-shift Scenario

The change in interest rates resulted into rate-shift scenario which is used for capturing customer behaviour.

For instance, if it is expected that the rates will rise to 2% then what will be the bank cash flow. If there will be increase in rates then there will be fluctuations in mortgage prepayments, prime lending rates and a consequent decline in the sanctioned loan.

So, the net present value is calculated for the new cash flows by using new rates. It helps in leading to the changes in expected earnings and expected value in different scenarios of interest rates.

3. Simulation Method

Bank's financial position, asset values, earnings or net incomes, influenced by several risks, are examined under simulation technique.

Simulation technique is performed in two environments,

(i) Static simulation

(ii) Dynamic simulation.

(i) Static Simulation

In static environment the on-balance sheet and off-balance sheet positions of current period are valued.

(ii) Dynamic Simulation

The dynamic simulation creates complete hypothesis about the future act of interest rates and sudden changes in the operations of the banks. Depending upon the user's need the output of simulation can be in various forms.

Simulation technique provides as,

(a) Current and expected periodic gaps

(b) Duration gaps

(c) Balance sheet and income statements

(d) Performance measures

(e) Budget and financial reports.

Simulation technique helps in setting the known risk exposure in various interest rates and balance sheet scenarios.

Thus, based on the available data, information technology and technical expertise, the ALM interest rate risk can be ascertained by using the above approaches (i.e., duration or gap analysis or simulation technique).

4. Duration Analysis

Duration analysis considers the time value of money for the cash flows to determine the gap. It focuses on the price risk and reinvestment risk at the time of managing the interest rate exposure. Duration analysis manages these two risks by analysing the affect of changes in the rates on the market value of the assets and liabilities and Net Interest Margins (NIM) by using the duration. After determining the duration, the affect of rate changes on NIM and market value of assets and liabilities of the banks can be analysed by calculating the gap for the portfolio of assets and liabilities.

Duration analysis or gap can be calculated as,

$D_S \times S = (D_A \times A) - (D_L \times L)$

Where,

D_S = Duration gap/duration of surplus.

D_A = Duration of assets

D_L = Duration of liabilities

A = Assets

L = Liabilities

S = Surplus/gap.

Whereas,

$L = A - S$

Thus, the duration gap is defined as the composite duration of liabilities and the multiple of the difference between composite duration of assets and the composite duration of liabilities and the asset - surplus ratio. Once the duration of the surplus is determined, the market value of the asset/liability needs to be calculated by the formula,

Change in the market value,

$$= \frac{-\Delta(\Delta \dot{r}) \times \text{Current market value}}{(1+i)}$$

Where,

D = Assets/liabilitie's duration

$\Delta\dot{r}$ = Variations in interest rates

i = Current interest rate.

Finally, the new market value (of assets and liabilities) can be computed by using the formula,

New market value = Original value + Change in market value

5. Hedging with Derivatives

A derivative is a type of financial instrument whose value is derived from the value of an underlying asset. Derivatives are also used for managing interest rate risk. The following are some of the major derivatives which are used to manage interest rate risk,

(i) Forward rate agreements

(ii) Interest caps, floors and collars

(iii) Interest rate swaps

(iv) Interest rate futures.

1.13.2 Liquidity Risk

Q30. Explain briefly how liquidity risk is measured.

Answer :

Liquidity risk is the risk that a bank, although balance sheet solvent, cannot produce sufficient cash resources to fulfill its payment obligations in full as they fall due. The liquidity risk arises due to the consequences in which one party though intended in bading an asset cannot do it, as nobody wants to bade that asset in the market.

In addition to market risk, credit risk and other risks; the liquidity risk has to be managed, because of its inclination to compound with the other risks. It is difficult to isolate liquidity risk. Certain techniques of ALM can be applied for assessment of liquidity risk. Regulators are primarily concerned with the systematic implications of liquidity risk.

The important activities of commercial banks are measuring and managing liquidity needs. The chances of risk of a critical situation can be reduced by liquidity management. The short fall of liquidity in one institution can affect the entire system. So, the liquidity limits the individual institutions. The liquidity position and the liquidity requirements should be measured by the bank management.

Through maturity or cash flow mismatches the liquidity can be traced because the assets, commonly said as liquid, become illiquid when market players are unidirectional. So, liquidity has to be traced through maturity or cash flow mismatches.

Calculation of maturity ladder and cumulative surplus/deficit funds is used to adopt a standard tool for measuring and managing net funding requirements.

For measuring the future cash flows in different time buckets, the maturity profile could be used.

The time buckets can be assigned as under,

1. 1 to 14 days
2. 15 to 28 days
3. 29 days and upto 3 months

4. Over 6 months and upto 6 months
5. Over 1 year and upto 2 years
6. Over 2 years and upto 5 years
7. Over 5 years.

There can be mismatches in each time bucket, depending upon the cash inflows and outflows.

The mismatches upto 1 year could be appropriate because it provides warning signals of approaching liquidity problems. Mainly the flows are on the short-term mismatches. The Board/management committee approves the banks to monitor their cumulative mismatches across all time buckets. If a bank needs higher tolerance level, in view of its asset-liability profile and the consequential structural mismatches, it can operate with higher limits by giving reason to the board/management committee. A higher tolerance level is intended for a temporary period till the 31st of March, 2000.

The structural liquidity statement can be made by placing all cash inflows/outflows in the maturity ladder. The cash inflow is a maturity asset and the cash outflow is a maturity liability. A number of assumptions are made for the determination of cash inflow/outflow, according to the asset-liability profiles. If the term deposit is high the Indian banks can afford to have larger tolerance levels in mismatches in the long-term. RBI is interested in ensuring that, by keeping all necessary factors in view of experience gained in liquidity management, the tolerance levels can be determined.

Banks may estimate their short-term liquidity profile, in order to enable and to monitor short-term liquidity, over a time period of 1-90 days.

Due to the lack of depth in secondary market the invest in SLR securities and other invest are assumed to be illiquid. Thus, some of the banks maintain securities in their "Trading books", the trading books are subjected to some of the preconditions for securities like,

1. Defining clearly the composition and volume.
2. Restriction of maximum maturity of portfolio.
3. Holding period of 90 days should not be exceeded.
4. Cut-limit should be prescribed.
5. Defeasance/holding periods should be prescribed.
6. 'Marking to Market' on daily/weekly basis revaluation of gain/loss charged to P and L account etc., should be prescribed.

The trading books complied with above standards by the banks are permitted to show the trading securities under 1-14 days, 15-28 days and 29-90 days time buckets based on the holding period (the time period used to liquidate the position based on liquidity in the secondary market).

The volume composition, holding period, cut-loss, etc., should be approved by the Board/ALCO of the trading books and the copy of it should be forwarded to the department of banking supervision of RBI.

1.13.3 Management of Credit Risk

Q31. "Credit risk is inherent to a financial intermediary and its management is perhaps more important than managing interest rate and liquidity risk". Explain.

Answer :

Credit Risk

'Credit risk' is the default risk wherein any one party indulged in contract with other party fails to fulfill his financial obligations. As this risk emerges from contractual parties. It is also called as counter party risk.

Management of credit risk is more important than managing any other type of risks. Credit risk helps in identifying the rights of counter parties and required level of cash flows. Credit risk management forms an important part of liquidity risk management and interest rate risk management as the former has an intricate linkage with the latter.

Credit risk management deals with analyzing and managing the issue of loans, diversification of loans and setting limits for granting credit and investment.

Credit risk can be effectively managed through the micro and macro-level approach.

(a) At the micro-level the credit risk management mainly focuses on each single credit transaction taking place in the bank.

(b) At macro-level the credit risk management focuses on the complete risk faced by the bank.

Credit risk management

Micro-level approach | Macro-level approach

Micro-level Approach

The important principles to be followed for effective management of credit risk are,

(i) Evaluation

(ii) Pricing

(iii) Monitoring.

1. Clients Proposal must be Assessed

Evaluation means careful and complete analysis of credit worthiness of different clients. Based upon this, the borrowers will be selected. Apart from credit assessment, the bank should also determine the willingness of the client to repay back the loan amount. Bank should follow certain variables for evaluating the clients proposal for loan. They are,

Evaluation of client's proposal

- Industry prospects
- Operational efficiency
- Financial efficiency
- Management evaluation

(a) Industry Prospects

To understand the prospects of an industry, an industry level credit analysis has to be carried out. This analysis includes the study of the following,

(i) Industry cycles

(ii) Products substitute

(iii) Change in demand of consumer

(iv) Regulatory framework.

(b) Operational Efficiency

In operational efficiency a firm's credit department conducts evaluation to understand the operational efficiency of the client firm. The important aspects that has to be evaluated in operational efficiency can be studied under the following heads,

(i) Profit margins

(ii) Stability and increase in the market share of a firm or bank

(iii) Permission to use key inputs

(iv) Advantages from the production economies of scale.

(c) Financial Efficiency

Whether a client can repay the loan amount or not depends on the financial strength of the client. Financial analysis is done using the following techniques.

(i) Financial leverage

(ii) Coverage of interest amount and principal amount

(iii) Cost of capital

(iv) Potential to raise funds

(v) Working capital management

(vi) Interest rate risk management

(vii) Exchange risk management

(viii) Sensitivity analysis.

(d) Management Evaluation

Management evaluation determines the client's willingness to repay back the loan amount. It involves the critical assessment of promoter's and top management performance of a selected companies which are working under the same management.

2. Pricing

Once the proposal and credit worthiness of a client has been assessed, the risk associated with the funding proposal needs to be calculated. This can be done through credit policies. Then a required return for these risk has to be identified with the help of a pricing policy. The expected return can be calculated by the following formula,

$$\text{Expected return} = P_1(r) + P_2\left[\frac{[P(1+r)R]}{P} - 1\right]$$

Where,

P_1 = Probability of repayment

P_2 = Probability of default $(1 - P_1)$

r = Contractual rate/interest rate

P = Principal component

R = Recovery rate.

A bank while pricing a loan proposal, have to set a contractual rate which reflects the ability of the client to repay.

(iii) Monitoring

Monitoring refers to a periodic review of the default risk involved in the proposal of grant loan to a client. Some important aspects need to be considered while monitoring involves,

(a) Past exposure to risk

(b) Initial steps of creditability

(c) Average delay or time gap in the payment of installments

(d) Performance of the client.

Macro-level Approach

Macro-level approach helps in determining wide and broader aspects related to the credit risk position of the banks. This approach can be followed by using Capital Adequacy Ratio (CAR) of the bank.

CAR is the ratio of a bank's capital to its risk weighted assets (RWAs) it explains the level to which possible losses can be covered by the capital.

$$\text{CAR} = \frac{C}{RWA}$$

Where,

C – Capital

RWA – Risk weighted assets

(or)

$$\text{CAR} = \frac{C}{A \times ARW}$$

$$= \frac{C}{A} = \frac{1}{ARW}$$

Thus, it can be observed that there exist an inverse relationship between CAR and risk weighted assets.

Contingent Risk

Contingent liability refers to a situation where banks do not grant loan directly but promise to bear a liability on behalf of its client to an uncertainty, which may or may not happen in future. The balance sheet does not consider such type of liability until and unless it happens practically. Because of this reason, contingent liabilities are referred to as off-balance sheet items.

1.13.4 Foreign Exchange Risk Management

Q32. Discuss briefly about the management of exchange risk.

Answer :

There may be fluctuations in the currency rates due to the uncertainties in the global markets, which could be due to demand and supply, trade deficit, interest rates and political stability and so on. Therefore, banks may be exposed to foreign exchange risk. There is risk to a strong currency, as compared to a weak one, depending upon the predictability of the fluctuation.

Foreign Exchange Risk

When business operates internationally, currency value tends to change in the foreign exchange market. Foreign exchange risks can be classified into three types. They are,

(i) Transaction exposure

(ii) Translation exposure

(iii) Economic exposure.

Relation between Exchange Rate and a Firm's Value

Value of a firm is directly affected by the changes in the currency value. Changes in the firm's value depends on the quantum of assets and liabilities valued in foreign currency, which are themselves exposed to foreign exchange risk.

$$\text{Domestic currency} \propto \frac{1}{\text{Value of assets and liabilities}}$$

Domestic currency is inversely proportional to the value of assets and liabilities. An increase in domestic currency decreases the value of assets and liabilities and vice versa.

The relation between the value of the firm and the exchange rate is given by,

$$\Delta k = \beta_1(\Delta S_u)$$

Where,

Δk = Change in the value of the firm

S_u = Unanticipated changes in the spot rate

β = Measure of sensitivity between Δk and S_u.

Foreign Exchange Exposure

It means, when the exchange rates changes, it effects the real domestic currency value of operating incomes, assets, and liabilities.

$$\therefore \quad \beta_1 = \Delta k / (\Delta S_u)$$

Foreign exchange exposure is classified as,

(i) Transaction exposure

(ii) Translation exposure

(iii) Operating exposure.

(i) Transaction Exposure

While operating business with other countries, a change in the value of foreign currency could cause a change in the value of home currency too. In a simple way, when the value of foreign currency increases then the home country needs to make higher payments, which in turn increases its expenses.

(ii) Translation Exposure

To diversify the business, any firm would invest in foreign countries by setting up their subsidiaries in those countries. Due to a change in exchange rates, the firm faces translation risk while preparing financial statements in terms of domestic currency.

(iii) Operating Exposure

In operating exposure, when the exchange rates changes it affects the future cash flows, which ultimately lead to a decrease in profits of the firm.

Managing Exposures

In order to manage all these exposures, hedging must be used. The person who hedges is known as hedger.

Example

A farmer who had to pay \$ 10,000 per ton of wheat a month later could hedge himself by entry into forward contracts.

Hedger makes use of both internal and external techniques for managing risk.

1. Internal techniques
2. External techniques.

1. Internal Techniques

Internal techniques uses three more techniques to manage risk under financial management.

Internal techniques involves the usage of firm's own financial management framework for the exposure management without the involvement of other company or agency in the process of risk management.

(i) Netting

Netting means, if a firm possess some assets in foreign currency and is also liable to pay certain amount in foreign currency, then both are balanced and in this way conversion is avoided.

(ii) Leading and Lagging

Leading means making the payment in advance; whereas, lagging is making the payment after the due date. This is done to avoid conversion and to reduce exchange risk.

(iii) Invoicing

When a firm wants to convert foreign currency into domestic currency or vice versa, then invoice is made.

2. External Techniques

When the exchange risk is transferred to the other, either partly or completely, then various external techniques are applied and they are,

(i) Forward contract

(ii) Currency futures

(iii) Currency options

(iv) Currency swaps.

1.14 ANALYZING BANKS FINANCIAL STATEMENTS

Q33. CAMELS constitute some of the performance rating used for the assesment of bank's financial statements. Explain the statement emphasizing on structure and objectives of Camels rating applied to Indian Banks.

Answer :

The banks are rated on the basis of various parameters that are based on financial and non-financial performance. Camels is one of the assesment technique commonly used. Each letter refers to a category of performance. The letters of CAMELS represent the following,

C-Capital Adequacy

The bank's ability to maintain capital in accordance with the nature and scope of types of risks is indicated by the capital adequacy.

A-Asset Quality

The amount of credit risk the bank is being exposed to due to composition and quality of loans, advances, investments and off-balance sheet activities is indicated by this measure.

M-Management Quality

The risk management policies and processes are used by the qualitative measures as the indicator of efficient management.

E-Earnings

This indicator reflects the trend of earnings and its amount. It also indicates the future expected growth in the earnings.

L-Liquidity

The bank's sources of liquidity and availability of satisfactory level of such sources is measured by liquidity.

S-Sensitivity to Market Risk

This is the latest addition to the parameters. It indicates the change in interest rates, exchange rates, commodity prices and equity prices.

Capital Adequacy

- Bank's size.
- Quantity of high quality assets.
- The growth of bank's experience, plans and prospects.
- Quality of capital.
- Retained earnings.
- Access to capital markets.
- Non-ledger assets and values not shown in the books.

Asset Quality

- Range of classification.
- Loans mentioned specially.
- Leveling, trending and comparing of non-accural and renegotiated loans.
- Range of concentrations.
- Range and type of insider transactions.

Management Factors

- Technological advancements, competence and the leadership of middle and senior management.
- Following banks laws and regulations.
- Satisfaction and adhering with internal policies.
- Capability of planning and responding to changing circumstances.
- Showing desire to serve genuine and valid credit needs of the community.
- Satisfactory of directors.
- Availability and adequacy of well qualified staff and programmes.

Earnings

- Averages and bank's own trends are taken for comparision with the ROA.
- Material components and income and expenses compare to peers and bank's own trends.
- Creating satisfactory provisions for loan losses.
- Quality of earnings.
- Maintaining dividend payout ratio in accordance to bank's capital.

Liquidity

- Satisfactory amount of liquidity sources in comparision to present and future needs.
- Availability of liquid assets.
- Permit to enter money markets.
- Funding sources diversification levels.
- The amount of reliability on short-term volatile sources of funds.
- Directing and stabilizing of deposits.
- Capability of securing and selling certain group of assets.
- The competency level of management for identification, measuring, monitoring and controlling liquidity position.

Sensitivity to Market Risk

- The financial institutions met earnings or economic value of it's capital's sensitivity to changing interest rates.
- Financial institutions acquisition of foreign exchange.
- Actual or potential sensitivity of earnings or capital to change in the value of trading portfolios or other financial instruments.
- Management's capability to identify, measure, monitor and control interest rate risk.

These ratings are used as regulators both internationally and in India.

CAMELS Ratings Applied to Banks in India

On-site inspection of banks on a periodical basis is the major supervision source in India. This inspection is based on CAMELS model. It focuses on achieving the following objectives,

- Analysing the safety and effectiveness of the bank.
- Improving the quality of board and top level management.
- Ensuring the compability with the regulations.
- Recognizing the area requiring corrective actions.
- Improving bank assets soundness.
- Evaluating major financial factors like capital, earnings, liquidity and solvency.
- Assessing the management's quality and evaluating policies, systems of management, internal operations and control of banks.
- Reviewing the compability with the laws and regulations of banks.

This frame work serves as a basis for financial performance parameters. They are also being used by certain banks for individual performance review process and for compensation to employees.

CAMELS model is used for rating the domestic banks, whereas the foreign banks are rated on CACS model. The inspection frequency is set in accordance with two financial position of the bank.

Apart from the information from CAMELS rating a large range of sources of information like market intelligence report, off-site monitoring and surveillance etc. are applied. The data is entered into the risk profile only after being evaluated for its significance and quality. The risk profit is updated regularly.

Q34. Explain the key performance indicators of banks. *(Model Paper-III, Q6(b)*

Answer : *[April/May-14, Q2(b) | May/June-12, Q2(b)]*

The performance of financial institutions have been affected by several external factors such as,

(a) Technology changes

(b) Competetion

(c) Regulation and

(d) Government Policies.

All these factors in addition to the internal factors affects the performance of the financial institutions. These factors are beyond the control of the bank's management. Instead of controlling them, the banks can predict the future changes and position the financial institutions order to grab the opportunities and benefits due to these changes. But, banks can control these factors by emphasing more on the key performance indicators. The KPI's for banks are as follows,

(i) Operating efficiency

(ii) Expense control

(iii) Tax management

(iv) Liquidity

(v) Risk.

Efficiency and Expense Control Ratios

The first three factors are included under efficiency and expense control ratios. These ratios outlines the efficiency of the financial institutions in controlling the expenses and costs in order to generate high revenues and the productivity of the employees in terms of revenue generation, asset management and account handling.

The following are the efficiency and expense control ratios,

(i) Operating Efficiency

Operating efficiency is defined as the ratio between total operating expenses and total assets.

$$\text{Operating efficiency} = \frac{\text{Total operating expenses}}{\text{Total assets}}$$

Interpretation

The lower the ratio, the higher will be the efficiency of the bank to meet the operating expenses effectively.

(ii) Cost of Funds

It is defined as the ratio between the total interest expense and the total borrowings including both deposit & non deposit borrowings.

$$\text{Cost of funds} = \frac{\text{Total interest expenses}}{\text{Total borrowings(deposit \& nondeposit)}}$$

Interpretation

The lower the ratio, the lower will be the variable cost for the bank.

(iii) Efficiency Ratio

It is defined as the ratio between the interest income and net total income. It is also called cost-income ratio.

$$\text{Efficiency ratio} = \frac{\text{Non interest income}}{\text{Net total income}}$$

Components

Net total income consists of both interest income and non interest income. The sources for non interest income include fee based services etc.

Interpretation

This ratio represents the contribution of non interest income in the total income generated for banks. Higher efficiency ratio represents the profitability of the bank.

(iv) Overhead Efficiency Ratio

It is defined as the ratio between the non interest income and the non-interest expenses.

$$\text{Overhead efficiency ratio} = \frac{\text{Non interest income}}{\text{Net interest expenses}}$$

Interpretation

It represents the efficiency of the bank to meet the non interest expenses.

(v) Income Productivity Per employee

It is defined as the ratio between the net income after taxes and the number of full time employees employed in the bank.

$$\text{Income Productivity per employee} = \frac{\text{Net income after texex}}{\text{Number of full the employees}}$$

Interpretation

This ratio represents the contribution of each employee towards the generation of net income for the bank.

(vi) Break even Volume of Incremental Cost/Employee

It is defined as the ratio between the costs incurred per employee and the net interest margin.

$$\text{Break even volume of incremental cost/employee} = \frac{\text{Cost per employee}}{\text{Net interest margin}}$$

$$\text{Net intrest margin} = \frac{\text{Net intrest income}}{\text{Total earning assets}}$$

(vii) Tax Ratios

Tax ratio is defined as the ratio between total tax payments and the income before taxes.

(i) $\text{Tax ratio} = \frac{\text{Total income tax payments}}{\text{Income before taxes}}$

(ii) $\text{Tax ratio} = \frac{\text{Tax Provisions}}{\text{Total equity}}$

(iii) $\text{Tax ratio} = \frac{\text{Tax Payments}}{\text{Total assets}}$

Liquidity

The term liquidity refers to the ability of a firm to meet the short-term obligations/requirements as and when they araise. Banks should satisfy the liquidity demands of investor. In general, the higher the proportion of liquid assets in the capital structure of the bank the lower will be the returns for the bank. The following ratio's explains the liquidity position of the banks financial institutions.

(i) Demand to Time Deposits

It is defined as the relationship between the total demand deposits and total time deposits.

$$\text{Demand to time deposits ratio} = \frac{\text{Total demand deposits}}{\text{Total assets}}$$

Interpretation

This ratio signifies the bank's need for liquidity. The higher the ratio, the more will be the need for liquidity.

(ii) Demand Deposits Ratio

It is defined as the ratio between the total demand deposits and the total assets of the bank.

$$\text{Demand deposits ratio} = \frac{\text{Total demand deposits}}{\text{Total assets}}$$

Interpretation

This ratio denotes the bank's need to invest in the liquid assets. If the banks have high number of demand deposit and then they require more number of liquid assets.

(iii) Non-deposit Borrowing Ratio

It is defined and the ratio between the non-deposit borrowings and the total assets.

$$\text{Non-deposit borrowing ratio} = \frac{\text{Non deposit borrowings}}{\text{Total assets}}$$

Interpretation

It denotes the probability of risk for the bank. The higher the ratio the more will be the default risk for the bank.

(iv) Credit-asset Ratio

It is defined as the ratio between the total credit offered by the banks and the total assets.

$$\text{Credit-asset ratio} = \frac{\text{Total credit extended}}{\text{Total assets}}$$

Interpretation

If the credit asset ratio is high then, the bank has to face high default risk.

(v) Net Loans to Asset Ratio

It is defined as the ratio between the total credit (without including any provisions made) and the total assets.

$$\text{Net loans to asset ratio} = \frac{\text{Total credit - provisions}}{\text{Total assets}}$$

Interpretation

The difference between the net loans to asset ratio and credit asset ratio denotes the credit soundness of the bank. If the difference is more, then the banks have weak credit portfolio.

(vi) Short Term Investments to Total Assets Ratio

It is defined as the ratio between the short term investments such as money market investments and other short term assets and the total assets.

$$\text{Short term investments to total asset ratio} = \frac{\text{Short term investments}}{\text{Total assets}}$$

Interpretation

This ratio denotes the liquidity position of the bank's portfolio. The higher the ratio, the higher will be the liquidity of the bank.

(vii) SLR Investment to Total Investment Ratio

It is defined as the ratio between SLR investments and total investments.

$$\text{SLR investment to total investment ratio} = \frac{\text{SLR investments}}{\text{Total investments}}$$

Interpretation

The higher the ratio, the higher is the liquidity of the bank's portfolio.

(viii) Cash to Demand Deposits Ratio

It is defined as the relationship between the cash balance of the bank & demand deposits.

$$\text{Cash-demand deposits ratio} = \frac{\text{Cash balance} + \text{Bank balance} + \text{Call money}}{\text{Demand Deposits}}$$

Interpretation

This ratio also denotes the liquidity position of the banks. The higher the ratio, the higher will be the bank's liquidity.

(ix) Cash to Total Deposits Ratio

It is defined as the ratio between the cash balance & the total deposits.

$$\text{Cash to total deposits ratio} = \frac{\text{Cash} + \text{Bank balances}}{\text{Total deposits (Demand \& Time)}}$$

Interpretation

This ratio is similar to cash reserve ratio.

(x) Cash to Total Assets Ratio

It is defined as the ratio between the cash balance and the total assets of the bank.

$$\text{Cash to total assets ratio} = \frac{\text{Cash} + \text{Bank balances} + \text{Callmoney}}{\text{Total assets}}$$

Interpretation

The higher the ratio, the higher will be the asset liquidity and lower will be the profitability of the bank.

Risk

The risks that are faced by the financial institutions/banks in their industry are insolvent loans or losses on investment. It is necessary for the financial institution managers to minimize these risks in order to sustain the competetion and to avoid bankruptcy. The following ratio denotes the ability of the banks to face the risks associated with their activities.

(i) Equity Multiplier Ratio

It is defined as the ratio between the total assets and the equity of the financial institution.

$$\text{Equity Multiplier Ratio} = \frac{\text{Total assets}}{\text{Equity}}$$

Interpretation

This ratio denotes the efficiency of capital structure of the institution.

(ii) Equity Ratio

It is defined as the ratio between the equity and total assets.

$$\text{Equity Ratio} = \frac{\text{Total Equity}}{\text{Total assets}}$$

Interpretation

The high equity ratio denotes that less risk is faced by the bank.

(iii) Capital Adequacy Ratio

It is defined as the ratio between the total capital and the risk weighted assets.

$$\text{Capital adequacy ratio} = \frac{\text{Total Capital}}{\text{Risk Weighted Assets}}$$

Adjusted capital adequacy ratio can be determined with the help of following formula,

$$\text{Adjusted capital adequacy ratio} = \frac{\text{Total Capital} - \text{Net NPA's}}{\text{Risk Weighted Assets} - \text{Net NPA's}}$$

(iv) Provision Ratio

It is defined as the ratio between the provisions made for losses on loans and total assets.

$$\text{Provision ratio} = \frac{\text{Loan loss provisions}}{\text{Total assets}}$$

(v) Net NPA to Assets Ratio

It is defined as the ratio between the net NPA's of banks and the total assets.

$$\text{Net NPA to assets ratio} = \frac{\text{Net NPA's}}{\text{Total Assets}}$$

Interpretation

The higher the ratio, the higher risky the bank is.

(vi) Net NPA's to Equity Ratio

It is defined as the ratio between the net NPA's and the equity

$$\text{Net NPA to equity ratio} = \frac{\text{Net NPA's}}{\text{Equity}}$$

(vii) Average Risk Weighted Assets

It is defined as the ratio between the risk weighted assets and total assets.

$$\text{Average risk weighted assets} = \frac{\text{Risk weighted assets}}{\text{Total assets}}$$

Interpretation

The higher the ratio the high risky the bank.

(viii) Incremental Risk of Asset Portfolio

It is defined as the ratio between the incremental risk weighted assets and incremental total assets.

$$\text{Incremental risk of asset portfolio} = \frac{\text{Incremental risk weighted assets}}{\text{Incremental total assets}}$$

Interpretation

The ratio represents the bank's ability to take the risks.

Q35. Write about various analytical tools available for the analysis banks financial statements.

Answer : *May/June-17, Q2(b)*

For answer refer Unit-I, Page Nos. 1.36, 1.37, Q.Nos. 33, 34.

SHORT QUESTIONS AND ANSWERS

Q1. CAMELS Ratings

Answer : *(Model Paper-I, Q1 | May/June-17, Q1(b))*

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- Recognizing the area requiring corrective actions.
- Improving bank assets soundness.
- Evaluating major financial factors like capital, earnings, liquidity and solvency.
- Assessing the management's quality and evaluating policies, systems of management, internal operations and control of banks.
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Q2. Financial Inclusion

Answer : *(Model Paper-II, Q2 | May/June-17, Q1(a))*

Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost.

– *Dr. C. Rangarajan,*
Chairman of the Committee of Financial Inclusion

Financial inclusion refers to a wide range of financial services at a reasonable cost. These include not only banking products but also other financial services such as insurance and equity products.

– *Dr. Raghuram G. Rajan*
The Committee on Financial Sector Reforms

Q3. Reasons for Nationalization of Banks

Answer : *May/June-16, Q1(a)*

The following are the reasons for nationalization of banks,

(i) When removal of adequate credit facilities are used in various sectors such as agriculture, small scale industries and exports.

(ii) When bank resources were not effectively utilized in the regional development programs.

(iii) When lack of social control is occurs in various illegal activities such as, holding secret reserve funds etc,.

Q4. Short Comings of Indian Banking System

Answer : *(Model Paper-III, Q5 | May/June-16, Q1(c))*

The various shortcomings in Indian Banking System are as follows,

(i) Banking facilities are not sufficient for all branches as a reason of huge population in India.

(ii) Lack of coordination between different banking organizations.

(iii) Indian banks are lagging behind in terms of adequate working capital and deposits when compared to foreign countries.

(iv) High non performing assets directly affecting the profitability of banks.

Q5. Define Bank.

Answer : *April/May-15, Q1(a)*

"A bank is a person or corporation which holds itself out to receive from the public deposits payable on demand by cheque".

– *Walter Leaf*

"A banking company is defined as one which transacts the business of banking which means accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawals by cheque, draft, order or otherwise".

– *The Banking Companies Act, 1949.*

A bank is "A manufacture of credit and a machine for facilitating exchange".

– *Horace White*

Q6. Sources of Risks in Banks

Answer : *April/May-14, Q1(b)*

The various sources or types of risk involved in Banking are as follows,

(i) Interest Rate Risk

(ii) Liquidity Risk

(iii) Credit Risk

(iv) Foreign Exchange Risk.

Q7. Write about liquidity and capital adequacy.

OR

Liquidity *April/May-14, Q1(d)*

(Refer Only Topic: Liquidity)

OR

Capital Adequacy

(Refer Only Topic: Capital Adequacy)

Answer : *May/June-13, Q1(e)*

Liquidity

The term liquidity refers to the ability of a firm to meet the short-term obligations/requirements as and when they araise. Banks should satisfy the liquidity demands of investor. In general, the higher the proportion of liquid assets in the capital structure of the bank the lower will be the returns for the bank.

Capital Adequacy

The bank's ability to maintain capital in accordance with the nature and scope of types of risks is indicated by the capital adequacy.

Q8. Bank-Customer Relationship

Answer : *May/June-13, Q1*

The relationship existing between a bank and customer comes into existence once an account has been opened with the bank and the fund have been deposited. The following types of relationship exists between the banker and a customer,

1. Creditor-debtor relationship
2. Agency relationship
3. Contractual relationship
4. Principal and agent relationship
5. Bailor and bailee
6. Mortgagor and mortgagee relationship
7. Trustee/constructive trustee.

Q9. SEBI

Answer :

The Securities and Exchange Board of India (SEBI) was setup on April 12, 1988 through an administrative order by the government of India in order to regulate the working of stock exchanges or secondary market with an aim to protect the rights of the investors, to prevent trading malpractices and thereby to build up a healthy and strong growth of capital markets. Although the SEBI was established on April 12, 1988 through an administrative order, but it became a statutory and really powerful organizations in the year 1992.

Q10. Discuss how RBI is controlled by central board of directors.

Answer :

The RBI is controlled by central board of directors which comprises of 20 members.

- One governor and four deputy governor's nominated by the central government as per the Reserve Bank of India Act, 1934.
- Four directors appointed by the central government under section 8(1(b)).
- Ten directors appointed by the central government under section 8(1(c)).
- One government official appointed by the central government under section 8(1(d)).
- The local boards of RBI consist of five members appointed by the central government. These local boards represent economic and territorial interest and the interest of cooperatives and indigenous banks.
- The governor is the chairman of Central Board of Directors of the RBI. In governor's absence, the Deputy Governor is appointed to exercise the powers of governor.

INTERNAL ASSESSMENT

I. **Multiple Choice**

1. Commercial banks are categorized as, ________. [ ]
   (a) Public sector banks
   (b) Private sector banks
   (c) Foreign banks
   (d) All the above
2. The main purpose of regional rural banks was to deliver ________ to the backward areas. [ ]
   (a) Payment services
   (b) Rural credit facilities
   (c) Credit-card facilities
   (d) None of the above
3. Commercial banks performs four major functions. They are Traditional functions, Incidental functions, Core functions and ________. [ ]
   (a) Ancillary functions
   (b) Letter of credit
   (c) Promotional functions
   (d) All the above
4. To control the liquidity risk through fundamental approach two methods are used. They are: Asset management ________. [ ]
   (a) Technical management
   (b) Deposits
   (c) Liability management
   (d) None of the above
5. Simulation method is one of the technique used to measure ________. [ ]
   (a) Liquidity risk
   (b) Foreign exchange risk
   (c) Credit risk
   (d) ALM Interest Rate Risk
6. ________ affects the incomes/expenses, value of assets/liabilities, and the market value. [ ]
   (a) Reinvestment risk
   (b) Basis risk
   (c) Real interest rate risk
   (d) Call/Put risk
7. In der micro-level approach, for credit-risk management three major principles are followed. They are, Pricing, monitoring and ________. [ ]
   (a) Evaluation
   (b) Operational Efficiency
   (c) Netting
   (d) None of the above

8. ________ is the default risk wherein, any one party involved in the contract with other party facts to meet his financial obligations. [ ]
   (a) Liquidity risk
   (b) Contengency risk
   (c) Volatility risk
   (d) Credit risk
9. Payment banks are restricted to take deposits only upto ________ per person. [ ]
   (a) ₹ 10 lakh
   (b) ₹ 20 lakh
   (c) ₹ 1 lakh
   (d) ₹ 2 lakh
10. 'Asset Quality' is one of the letter of the ________ abbreviation. [ ]
   (a) Key Performance Indications
   (b) CAMELS
   (c) Asset Liability Management
   (d) None of the above

II. Fill in the Blanks

1. The "banker-customer" relationship was traditionally termed as ________ relationship.
2. ________ is referred as an entity (or) an individual carrying-out transactions with the banks.
3. Retail banks focuses on ________ instead of corporate clients.
4. Private banking is also referred as ________.
5. ________ plays a major role in the development of an economy.
6. The term CAMELS stands for ________.
7. Non-deposit funding sources are also termed as ________.
8. 'Offering trust services' is one of the ________ services offered by banks.
9. Selling retirement plans is one of the modern services offered by ________.
10. The various sources of funds for banks are equity, reserves and ________.

KEY

I. Multiple Choice

1. (d)
2. (b)
3. (a)
4. (c)
5. (d)
6. (c)
7. (a)
8. (d)
9. (c)
10. (b)

II. Fill in the Blanks

1. Debtor and Creditor Relationship
2. Customer
3. Customers
4. Personal banking
5. Commercial Banks
6. Capital Adequacy, Asset Quality, Management Quality, Earnings, Liquidity Sensitivity to market risk
7. Wholesale funding sources
8. Traditional services
9. Banks
10. Borrowings.

III. Very Short Questions and Answers

Q1. Write a short note on the structure of Indian Banking System.

Answer :

The banking structure in India consists of commercial banks, financial institutions, non-banking financial companies and co-operative credit institutions.

Q2. What is a Scheduled Commercial Bank?

Answer :

The scheduled commercial banks constitute those banks which have been included in the second schedule of RBI Act 1934, vice-versa for unscheduled commercial banks. These banks are further classified or subdivided by RBI as public sector banks, old private sector banks, new private sector banks and foreign banks.

Q3. Define Universal Banking.

Answer :

Universal banking signifies broad-based and comprehensive banking activities that deals with working capital requirements as well as term loans for developmental activities of individual customers as well as big corporate customers. It is also referred as the development phase of financial markets which act as a link between banks and industry.

Q4. Write a short note on RBI.

Answer :

RBI is a monetary authority and central bank of the country. It has the power to manage, develop and regulate the financial system. It is a financial institution of Indian financial system. It plays a vital role in banks management as it is responsible for the task of control, supervision, promotion, development and planning the activities of bank management.

Q5. What do you understand by Bank-Customer Relationship?

Answer :

The relationship between a bank and customer comes into existence once an account has been opened with the bank and the fund have been deposited. Credit-debtor relationship, agency relationship, contractual relationship, principal and agent relationship. Bailer and Bailee are some types of relationships exist between a banker and a customer.

UNIT 2

Uses of Bank Funds

LEARNING OBJECTIVES

After studying this unit, one would be able to understand,

- The Features of Bank Credit.
- Different Types of Lending Practices.
- Different Types of Accounts.
- The Procedure for the Assessment of Credit-Worthiness of the Borrower.
- The Credit Process and Management.
- Different Features of various Types of Loans offered by the Banks.
- Various Models for Pricing the Loans.
- The Concept of NPA's and it's Implication and Recovery.
- The Concept of Priority Sector Lending.

INTRODUCTION

Banks play an important role in the financial system of the country. Banks are the financial institutions which basically deals with the task of managing the credit risk associated with it's funds. They also performs the intermediary function between the public depositing funds and public lending funds. They play a catalytic role in the economic development of the country developing and promoting the rural development and the other sectors of India. Banks possess well diversified credit portfolio in order to assure the high asset quality and also have limited levels of exposures. Banks usually offers credit to public in the form of loans. While lending funds/loans, the Bank, needs to consider the creditworthiness of the borrower and price of loan in order to minimize the credit risk involved with it and also to reduce the accumulation of NPA's in the bank accounts.

2.1 BANK CREDIT – CONCEPT AND FEATURES

Q1. What is bank credit and list out different features of bank credit?

Answer :

Bank Credit

Bank credit refers to the credit which is being extended by the banks to borrowers or applicants. Irrespective of whether the borrower withdraws the credit amount or maintains it as a deposit with the bank, in both the cases involves the credit extended. Immediate withdrawal on late withdrawal of the credit extended does not really matter.

The credit is extended by banks to different borrowers for different purposes. The bank tends to be one of the basic and cheapest source of debt financing. The bank credit is quite essential for both the demand and supply side of the economy. The consumers form the demand side of the economy and requires bank credit for purchasing the consumer durables, housing or plain consumption. Whereas the supply side consists of corporate and government sectors which requires bank credit for long-term purposes and for daily operations i.e., in the form of working capital.

Providing finance to the demand side of the economy i.e., to the large class of consumers is referred to as retail banking and financing the supply side of the economy is known as the wholesale or corporate or class banking.

The bank credit is quite similar to the process where in the goods are being sold on credit by a merchant to a customer.

Features of Bank Credit

The following are the features of bank credit,

1. **High Returns**

The bank credit ensures higher returns. These returns comes either in the direct interest based form or indirect fee-based form. The borrowers also add to the deposits by reinvesting the credit in the bank.

2. **Credit Risk**

The bank credit also includes a credit risk which arises from the borrowers default to repay the loan. It is also known as default risk. This risk also arises from various reasons such as problems in borrower's businesses like labour problems, technological obsolescence, and changing customer preferences.

3. **Provisions**

Bank credit is usually lent by the bank by creating a certain provision in to recover the expected losses arising out of the credit risk.

4. **Interest-rate Risk**

The bank credit also includes the interest rate risk. The cash inflows are affected by the fluctuations in interest-rate and these fluctuations give rise to volatility earnings.

5. **Risk-based Capital Standards**

The bank credit requires the banks to maintain a predicted amount of capital for each loan granted. The banks should maintain this capital in order to ensure growth while lending.

6. **Securitization**

The banks lending bank credit may adapt securitization. Under this the banks don't lend any credit but instead gets involved with the borrower either as an underwriter for arranging finance or by issuing a letter of credit to import inventory rather than acquiring the finance inventory. These services ensure a fee-based income for banks.

2.1.1 Types of Lending

Q2. What are the various types of lending and explain them in brief?

Answer :

Lending is a practice of borrowing funds from a source of finance. Lending is basically of three types,

1. Fund based lending
2. Non-fund based lending
3. Asset based lending.

1. Fund Based Lending

Fund based lending is one of the direct form of lending wherein a bank can issue cash directly to the borrower in the form of loan or advance. Banks provide fund based lending by assessing the securities of the borrowing firm. It is further categorised into three types on the basis of maturity period of loans.

(i) Short-term loans

(ii) Long-term loans

(iii) Revolving credit.

(i) Short-term Loans

Short-term loans are the loans which are provided by the banks usually with a maturity period of less than or equal to 1 year. The short-term loans are usually being granted with a basic objective of financing working capital needs of the borrower, arising out of the temporary build up of inventories and receivables. The short-term loans are of two types,

(a) Secured loans

(b) Unsecured loans.

(a) Secured Loans

These loans include the loans to meet working capital needs and seasonal line of credit.

- **Loans to Meet Working Capital Needs**

  These loans arise due to inability of borrowers to meet the working capital needs and to maintain inventory and receivables. Borrowers will repay the loan after generating cash flows from the current assets.

- **Seasonal Line of Credit**

  Banks will also issue seasonal line of credit to borrowers in order to sustain the seasonal fluctuations in sales through providing immediate current assets. Banks will grant credit of an interest after determining the necessity of borrowers in order to meet the seasonal demand. The repayment is structured based on firm's ability to generate cash in flows from sales and inventory.

  These loans are granted by considering the credit worthiness of the borrower to repay in terms of firm's securities including prime and collateral. Prime securities will affect the loan amount directly whereas collateral securities exist along with prime securities and indirectly influence the activities of borrower.

(b) Unsecured Loans

Unsecured loans are provided for special purposes of firms. They include temporary changes in current assets, temporary cash crunches etc. Banks will grant these loans after assessing creditworthiness of the borrower on certain acceptable terms and conditions. Borrowers need to pay interest and principal at the time of maturity which is called a bullet. The maturity period for the loans can be determined by considering the ability of borrowers to generate cash flows. These loans involve certain credit risk because of unexpected changes in conditions.

(ii) Long-term Loans

Banks have been providing long-term loans to the firms since 1930. The features of long term loans include,

(a) The maturity period of long term loans is more than 1 year.

(b) These loans are more appropriate for the firms to satisfy specific needs.

(c) The maximum maturity period for these loans is 10 years or on an average of 3-5 years.

(d) Borrowing firms should repay the loan by generating cash flows from sales but not by liquefying it's current assets.

(e) The main objective behind providing long-term loans is to facilitate the firms in acquiring the fixed assets or to restructure the firm or to meet permanent working capital needs of firm.

(f) The loan amount should not exceed the financial need of borrowers.

(g) The securities for the bank in case of long-term loans include the right of a bank to claim on the fixed assets of borrowing firm.

(iii) Revolving Credit

Through revolving credit, banks will provide flexible loan structures to borrowing firms for drawing the loan amount and to repay it. They can repay the loan at the time of cash flow generation only. These loans are provided by banks after determining the firm's need for finance, securities and it's creditworthiness to repay it.

Sometimes, it is also possible to convert the revolving credit to any type of term loans for maturity.

2. Non-fund based Lending

Like fund based lending, banks will also provide non-fund based lending to borrower firms. Non-fund based lending practices include letters of credit, bank guarantees etc. In this, banks will act as surity on behalf of customers by entering into an agreement with the party lending the actual funds. If the customer failed to repay the amount to the concerned party bank should be held liable for that and need to pay that amount which is again an fund based practice. This liability is called contingent liability on part of banks.

3. Asset Based Lending

The practice of asset based lending is still emerging and is a specialised form of lending practices. In Asset based lending, bank will provide/grant loans based on the functioning of asset and the capacity of the asset to contribute for repayment. This lending practice include securitization, project finance etc. In these lending practices borrower is not responsible or sometimes limited liable for loan repayment.

2.2 DIFFERENT TYPES OF ACCOUNTS

Q3. Explain in detail about different types of accounts.

Answer :

For answer refer Unit-I, Page No. 1.25, Q.No. 24.

2.3 STEPS TO BE FOLLOWED IN THE ASSESSMENT OF CREDIT WORTHINESS OF A PROSPECTIVE BORROWER

Q4. Explain the steps to be followed in the assessment of credit worthiness.

April/May-15, Q3(a)

OR

Explain the steps to be followed in the assessment of credit worthiness of a prospective borrower.

Answer : *(April/May-14, Q3(a) | May/June-13, Q3(b))*

The following are the steps to be followed for assessing the credit-worthiness of a prospective borrower,

Step 1: Creation of Credit File

This is the first step for assessing the credit-worthiness of the borrower. The credit file is created, after gathering information related to credit-worthiness of the borrower, his history of credit and track record. The projects related to Green-field require special research into the project and also requires research into the borrower's financial and managerial ability to make the project a success. The credit officer conducts all these researches, however if an existing borrower requires additional credit this information is readily available. The credit file is very vital for the credit officer as it includes all details related to the borrower such as past and present statements, call report summaries, cash flow projections, future plans, related credit reports, insurance coverage details, fixed and other assets, collateral values and security documents. In case of an existing borrower it includes the documents related to previous loans, the comments of loan officers and the customers messages. The credit officer should carefully analyze the details of the credit file before moving on to the credit analysis.

This file is crucial as it helps in identifying the borrower's ability to repay the loan and gives a clear idea about his intention and potential of repaying loan.

Step 2: Project and Financial Appraisal

After collecting the information related to the borrower the next step involves the analyzation of various internal and external factors. These factors include management's integrity and capability, the performance of the company, its market value and the evaluation of industry's characteristics.

Financial analysis is the crucial activity in this step. Basically, this step involves the following activities,

- The audited past financial statements of the borrower are examined. These statements must be in bank's own format and past 2-3 years statements must be presented.
- The cash flow statements are also examined to determine the borrower's usage of even and borrowed funds.
- With the availability of the above data the liquidity of the borrower can be analysed by the credit officer. Sufficient liquidity level indicates the borrower's quick capability to repay the loan and vice-versa. A set of financial ratios are used to determine the liquidity.
- The amount of debt, the business has incurred in comparison to owner's stake determines the entity's financial risk. To increase the debt amount set by banks for different borrowers, the borrowers are required to increase their own stake. The tangible net worth is the focus of credit officers for measuring owner's stake in the business.
- After examining the financial health of the borrower, the quality of projected cash flows is analysed for determining, his debt servicing capability. The borrower's projections are questioned by the credit analyst until he is satisfied. The sensitivity analysis are also carried-out for testing the chances of success, for the projection.
- The future uncertainties cannot be determined even in case of a thoroughly done projection. Therefore the next best option for repayment is also taken into consideration by the credit officer.

Step 3: Qualitative Analysis

Honesty of the borrower is the most important quality that the banker looks for. However it is the most difficult quality to assess. The assessment of quality of the management team is also difficult. The lenders are required to perform qualitative assessment on the basis of various criterias.

Step 4: Decreased Devotion

Providing a hundred percent devotion is costly and time-consuming for the banks. But this is worth the effort. Devotion refers to cross-checking of the borrower's address, borrower's work place and it preapproves the interviews with competitors, suppliers, consumers and employees of the borrower. Ignorance of this step has resulted in problems in recovery of loans for banks in the past. The disclosure of contingent liabilities of the borrower is also crucial activity in this step.

Step 5: Risk Assessment

In this step, the credit officer recognises and analyses the basis risks associated with the recommended risk. Various internal and external sources of risk and their impact on the borrower's expected returns are analysed. This is an important factor for designing the credit facility and terms of the loan agreement.

The risks are divided into various categories. These categories help in identifying one severity of risks.

Step 6: Making the Recommendation

After all the steps have been carried-out successfully the credit officer makes his recommendation, of either favouring or rejecting the loan. In case of old clients the credit, officer recommends various options to improve the financial conditions and repayment options. At this step the decision of granting or rejecting the loan amount is taken. If the loan is to be granted, the credit officer then specifies the credit terms with relation to maturity period, pricing, loan amount and other details with the borrower.

Q5. "The lender with a close knowledge of his borrower has an offensive and defensive edge". Explain.

Answer :

The lender with a close knowledge of his borrower has an offensive and defensive edge. This is possible only if the banker maintains a healthy relationship with the customer or borrower. Focusing too much on the customer's interest or avoiding the relationship during the difficult times does not allow the lender to have this defensive and offensive edge.

The development of difficulties and turning down of businesses makes the loan officers understand that their knowledge of credit has increased from the time of approval of credit. These difficulties usually arise due to the following reasons,

1. **Weak Financial and Management Controls**

The businesses tend to have a weak financial control. Therefore, they are unable to exercise control over the outflow of funds. This results in failure of recovery of credit. Similarly the firm may be having a weak management, which has a limited or no control over the business operations.

2. **Losses in One Business Adjusted by Profits of Another**

The setting-off of losses in one business with the profits of another may also give rise to the difficulties of repayment of credit.

3. **Headstrong Mismanagement**

The management is headed by a single man, who is completely unaware of the management techniques and hardly has any management knowledge.

4. **Fad Products**

The products being produced may not be technologically advanced.

5. **Marginal Products**

The products of the business may be of minor importance.

6. **Brilliant but Erratic Behaviour**

The performance of the business may be brilliant but on as irregular basis. Therefore, the absence of regular pattern of behaviour has a direct impact on the businesses credit worthiness.

7. **Over-Reaching**

The businesses may true too hard to reach the target customers, this may result in failure. This failure directly impacts the borrower's ability to pay back the credit.

8. **Poor Business Strategy**

The business strategy adopted by the borrower may be poor and may result in failure.

9. **Untested Borrowers and Management**

The unexperienced borrowers and management may also be the reason for the failure of the business.

10. **Absence of Business Fundamentals Appreciation**

The borrower may lack the ability to appreciate the business fundamentals that are the key for business success.

In order to ensure success, efficient performance and survival, the businesses must focus on factors such as technology and customer preference. However the success doesn't last forever.

In small communities the loan officers are able to understand their borrowers in a better manner as the customer base is fixed. A larger market place results in more changing and informal customer base.

Q6. Explain the relationship between the senior management and the behavioural factor.

Answer :

The senior management should be committed towards a sound credit practice by distinguishing and being real at every level of lending. The credit practice based on gaining market share or profit does not ensure a sound credit practice or impossible to achieve a good credit practice. The increased attention of public towards banks in combination with the suffering bank share prices ensures the evaluation of behavioural factor by the management.

The following five major studies ensures achievement of appraisal,

(a) Examination of past and projected financial statement for calculating share holding spread, range and marketing capability of manufactured products and so on.

(b) Trend analysis can be done in two ways,

(i) By collection of previous 3-5 years of audited financial statements.

(ii) On the basis of projected financial statements and other data resulting from a year or two.

(c) Determining the flow of short-term funds and their planning and control methods and the level to which they have been controlled by the firm through examination of past and projected funds flow.

(d) Estimating the funds required by firm in both short-term and long-term.

(e) The review types and control measures that must be introduced for determining,

(i) The level of accuracy for past projections and estimates and high lighting the reasons for variations.

(ii) The advancements that could be made in forecasting or budgeting techniques of customer for increasing the accuracy in future.

The level of safety on loan or advance is the major determinant of lending decision, type and amount of credit to be lent and the terms and conditions of the advance. Basically, two types of approaches are followed by banker to ensure the safety of loan. They are as follows,

(a) Pre-sanction Appraisal Approach

It focuses on measuring the risk involved in the loan proposal. More advanced principles of lending have been developed by banks. These principles don't form a part of any legislation. However they are divided into the following categories,

1. Acceptable Borrower

The customer should have sufficient amount at stake and the banker should have confidence in this honesty and ability to run the business. The customer should not be involved in speculative business and should neither be under trading nor overtrading.

2. Acceptable Business

The government policies, BI policies and bank's own policies differ according to the nature and purpose of business. These policies determine the amount of loan to be granted. The banks provide loans to businesses that earn sufficient returns and moreover avoid lending to the low-priority sector.

3. Acceptable Purpose

Banks mostly provide short-term loans. Therefore, the banker focusses on the short-term resources gap coverage of the customers. The banker lends long-term loans or term loans only for certain purposes.

4. Acceptable Repayment Programme

The banker expects the repayment of short-term loan within a short-time period. He wishes to maintain a liquid portfolio as soon as possible.

5. Acceptable Security

A profitable business earning good returns and being managed by honest people is believed to be the best security. But depression period has a negative impact on every business. Therefore, the banker requires security against such situations. The security may either be in a form of goods or collateral securities.

(b) Post-sanction Appraisal Approach

The post-sanction approach widely depends upon the results of pre-sanction approach. The customer is believed to be the first class risk. The banker does not lend to an unsatisfactory business and if it does, it ensures regular follow-ups and strict control measures.

Therefore, careful selection of the customer, correct appraisal of his credit needs and sufficient control by banks over his dealings and acceptance of terms and conditions of lending are the key factors for the successful lending.

Q7. Discuss about "follow-up mechanics" in detail.

Answer :

The sanctioning and paying out of financial funds to the customer is not the end task of the bank. The banks must follow-up projects to ensure that the enthusiasm by which they were launched or financed by banks are generating desired cash flows and socio-economic gains. The reasons of deviations in the results and their impact on the objectives of the project. Once the banker has agreed to grant loan to the customer the relationship between the financial institution and customer is said to have been formed. This relationship continues till the project life. The two basic objectives of follow-up policies of financial institution are,

- To monitor the progress of the project. This ensures keeping track of whether the project is achieving the desired results or not.
- To develop a partner relationship with the customer, so as to ensure continuous realisation of interest throughout the assistance period.

A regular reporting relationship is maintained by the banks in India with the assisting concerns. This relationship is maintained in the following ways:

(a) Acquisition of production reports submitted by assisted concerns to the concerned administrative authorities.

(b) Acquiring the quarterly/monthly progress reports submitted to the bankers and others by the assisted concerns.

(c) Collecting the financial statements on accounts from assisted concerns on a half-yearly or yearly basis.

(b) Visiting/inspecting the sites on a periodic basis and ensuring that the performance of the project is in accordance with the operating plans.

(e) Forcing a need based system for management of information and control within the organization and

(f) Collecting the reports from the board of directors of assisted concerns and observing the developments in operations and management that take place from time to time.

The banks also conduct an informal discussion with the promoters/senior executives of assisted concerns of a timely basis as a support to reporting relationship. In certain cases the periodic reports are also collected from internal/ concurrent auditors/management or technical consultants appointed for monitoring the progress.

The financial institutions follow-up measures and reporting relationship aims at continuously creating better awareness of financial principles and managerial importance among entrepreneurs and promoters, for the success of the venture. Efficient management and motivated promoters now perform upto the required mark. The follow-up procedures and reporting relationship of the financial institutions are very much sleek today. They provide only the required information to the management of the project and ensures success in its operations.

2.3.1 Credit Analysis and Credit Appraisal

Q8. Explain the concepts of credit analysis and credit appraisal.

Answer :

Credit Analysis

The profitable and safe management of bank assets is the main principal of the bank assets management. Granting of loan is the most profitable as well as the most risky function for the banks. In order to mange the funds effectively, efficiently and with minimum risk an appropriate operative credit management and credit analysis is required. The credit analysis aims at collection of applicant related information. The capacity of the borrower, his ability and willingness to repay the loan amount on the basis of agreement terms are determined by the credit analysis. The credit analyst collects the information related to the borrower and use the financial statements to determine various ratios. These rations indicate the borrower's liquidity and ability to meet the loan agreement terms.

The nature of the company its management, its financial strengths and other factors are also considered by the credit analyst. The analyst then determines the borrower's to meet the credit terms. This information serves as a basis for the decision of granting or not granting loan/credit.

Sequential Investigation process

A more detailed analysis must be conducted only when the credit decision taken on the basis of past analysis is expected to change and sufficient information is available. Each step towards further analysis results in increase in cost of investigation.

In sequential investigation process of credit analysis the first step involves the analysis of past experiences. The second step is the ordering and evaluation of Dun and Bradstretis report on the applicant. The last step deals with inquiring of credit history with the borrower/applicant's bank and creditors. Favorable past record ensures less risk and risk and requires less amount of investigation. Whereas in cas of riskier applicant more information and investigation is required.

Credit-Scoring Systems

Various quantitative methods are used to determine the ability of the business to meet the credit loan. The final decision of granting credit however lies with in the hands of the credit analyst. The granting of credit to retail consumers have proved to be successful with the strict numerical evaluations. This system may also be used for providing extended trade credit, by companies.

Credit Appraisal

The analysing of the financial, technical and managerial practices of firm's operations for estimating the need and end-use of short-term funds should be the basic goal of the revised system. The well-managed firm tends to be a better risk for the bank than the good will or amount of assets it holds.

According to the banker the credit appraisal involves in depth analysis of firm's past and projected financial profitability from its operations, specifying the need, purpose and amount of short-term credit and the follow-up and control measures for ensuring that the firm's operations are in accordance with the expectations, and short-term funds are being utilised for the purpose they have been borrowed.

2.4 THE CREDIT PROCESS AND MANAGEMENT

2.4.1 Credit Process – Steps and Constituents

Q9. Describe briefly about the credit process and it's constituents.

Answer : *Model Paper-I, Q7(a)*

Credit Process

The credit decisions of a credit officer/lender should follow certain guidelines to avoid the risks associated with their practices. Banks will grant credit only after assessing the trade-off between risk and return as the credit decisions have a significant impact on the bank profits and competitiveness.

Credit officer should balance the conflicting objectives, market value objectives, returns, liquidity requirements, capital requirements etc. Before granting the credit, credit officer should analyse the risk involved in each opportunity and take decisions by considering the bank's strategy. In case of risky projects, credit decisions become highly judgemental and require highly expertised credit officers. The decisions of credit officers mostly effect the bank's profitability. Thus, credit officer play a significant role in lending practices.

Steps of Credit Process

The major steps involved in the credit process are as follows,

Step-1

The credit process starts with the thorough analysis of credit worthiness or willingness of borrower to repay a loan/credit.

Step-2

After the analysis, the credit officer of bank proposes a loan structure for approval in bank on behalf of borrower.

Step-3

In the last step of credit process the determination of risk rating for the credit and approval or rejection of loan.

Constituents of Credit Process

Credit process constitute the following elements. They are,

(a) Loan policy
(b) Business development and recommendations
(c) Credit analysis
(d) Credit delivery and administration
(e) Loan documentation
(f) Terms and conditions of lending
(g) Updating credit file and followup
(h) Credit review and monitoring.

(a) Loan Policy

Banks should craft loan policy that are authorized by board of directors of bank in order to co-ordinate the individual credit officer's goals with the bank goals. In loan policy the manager has to prepare guidelines that are to be followed while lending loans to borrowers. The loan policy should throw light on bank's lending strategy, requirements for lending, standards, procedure for assessing, appraising, granting, documenting and reviewing. Loan policies are structured based on the best practices followed in industry and their past experience. The lending practices of bank can be accepted by the regulators through assessing whether the loan policies are framed according to the standards or guidelines. The components of a loan policy document include,

(i) Lending objectives
(ii) Structure of loans
(iii) Procedure of loan evaluation
(iv) Administration of credit
(v) Credit files
(vi) Lending rates and
(vii) Others including incentive schemes, loan agreement terms, credit monitoring system, degree of security, type of securities and repayment structures.

(b) Business Development and Recommendations

In order to accomplish the objectives of bank to build the loan asset portfolio, credit officer is required to build harmonious relationships with long standing customers, attract new customers and offer non credit services to customers. The main aim of employees from operational level to strategic level is to develop the business through credit development. It is necessary to minimize the risk by avoiding bad loans through proper assessment of each borrower.

Banks can expand it's credit operations starting from market research and credit investigation determine business plan for it's development. This plan forms basis for bank to proceed in order to attract new customers and retain existing customers. In order to attract corporate borrowers credit officers structure call programmes and encourage these customers to request for loans.

After this credit officer proceed to further steps by appraising the borrower using financial statement, credit records, liquidity requirements etc., credit can assess credit-worthiness of the borrower and debt servicing capacity by analysing the risks associated with lending and borrowing firms. The following aspects should be considered while appraising a borrower,

(i) Risks involved in the firm.

(ii) Borrower antecedents, management integrity and credit record.

(iii) Financial risks.

(iv) Operational risks involved.

(v) Borrower's activities to minimize the risks.

(vi) Banks measures to recover loan under risk.

(vii) Risks that are to be considered while granting loan and suggestions provided to minimize the risk.

Credit officer should consider the following factors affecting the credit decisions. This include,

- Credit-worthiness of borrower
- Securities
- Firm's operations
- Relations with borrower.

These factors are referred to as cannons of lending consists of 5 c's, capital, capacity, collateral, conditions and character, other models include "CCC", "CAMPART" and "PARTS".

The basic assumption underlying all the models is the past performance of borrower forms basis for future repayments. In recent days the credit-worthiness of borrower can be assessed using ratio analysis and other risk evaluation models. Lender will grant loan only if the borrower satisfies the lending requirements.

(c) Credit Analysis

For answer refer Unit-II, Page No. 2.7, Q.No. 8, Topic: Credit Analysis.

(d) Credit Delivery and Administration

Decisions regarding the credit grants are taken by the authorized officers of the bank at each level of hierarchy. In general, banks set discretionary limits for credit decisions for each level of management right from credit officer to top management of bank. Discretion limits for credit officers are very less whereas the limits will increase while moving upwards in the hierarchy towards top management. If the loan requirement amount exceeds the limit of regional or territorial or corporate office then they will refer it to top management where the ultimate decision has to be taken by the board of directors. Usually the final decision of top management are based on appraisal given by the credit officer. Thus, they play a very important role in taking effective credit decisions. Most of the times top management accepts effective decisions recommended by the credit officer who have conducted extensive search.

(e) Loan Documentation

It is necessary for a borrower to undergo loan documentation processes mentioned under legislation. Borrowers and guarantees can execute loan document after completing the formalities of loan agreement. Borrowers should be clear in terms of securities if necessary bank will have a right to liquidate the assets in order to recover the loan.

(f) Terms and Conditions of Lending

Both borrower and guarentor should agree on the terms and conditions mentioned in the loan agreement. Terms and conditions represents the bank's right and control on the borrower's firm and to minimize the risk associated with it. Terms and conditions consists of the following elements,

(i) Conditions Precedent

Conditions represents the bank's requirements that must be satisfied before approving loan to borrower. They include auditor's certificate, legal opinions and need for credit. The primary condition is material adverse change clause for financial statements and cashflow projections. If there is any change in the material after granting loan this clause will facilitate the bank to recover the loan by minimising the risk.

(ii) Representations and Warranties

Banks will provide loan to a borrower based on the reliable information furnished by the borrower. Before executing the loan agreement borrower should insure the reliability and validity of the information furnished by him. If any misrepresentations or invalid information provided is considered as an "Event of default" by bank. The representations consists of,

- Information should be reliable and accurate.
- Borrower firm should be an authorised one.
- Guarantees are also an authorised persons.
- Borrower should meet all obligations inforced by law.
- Borrower should complete all the statutory proceedings.
- Securities should be mentioned clearly for liquidation.

(iii) Convenants

Convenants constitute an operational part of terms and conditions. These are the actions, the borrower should follow while performing his future operations by establishing standards, code of conduct etc. Usually credit officer make use of convenants to minimize the risks associated with Borrower firm and lending practices. Violation of these actions constitute event of default. Convenants are of two types.

- Affirmative Actions and
- Negative Actions.

Affirmative Convenants

These actions should be followed by borrower to perform operations according to legislation. In affirmative convenants borrower should ensure,

1. Need for credit
2. Financial health of firm
3. Record and controls
4. Statutory obligations
5. Reports of financial and operational performance to banks
6. Insurance details of securities
7. Maintenance of fixed and current assets of firm
8. Right of bank to inspect the assets.

Negative Convenants

Through negative convenants bank will control the operations of borrowers. They are specified in order to avoid ineffective-managerial decisions and to enhance the credit-worthiness of the borrower. The main aim of these convenants is to enhance financial healthy firm for timely repay. Negative convenants include restrictions on,

1. Capital expenditure
2. Investment of funds
3. Outside liabilities, subsidies and investing other firms
4. Sale of assets
5. Dividends and debt payments in advance
6. Capital structure
7. Mergers and share purchases
8. Risk associated with assets of borrower firm.

Event of Default

The violation of any of the terms and conditions mentioned in loan agreement constitutes an "event of default" which will result in loss of banker-borrower relationship. The actions of borrower are considered as events of default, if they fail to,

1. Repay the principal and interest within stipulated times.
2. Violation of convenant actions.
3. Represent accurate and valid information.
4. Communicate with bank regarding movement of funds, changes in management structure etc.
5. Perform liquidation processes.
6. Provide accurate records/reports about periodic financial performance of firm.
7. Enter valid agreements.
8. Follow the material adverse change clause.

The penalty and punishments for the conduct of event of default depends on the bankers. As the banker-borrower relationship is significant for both parties. Bank would not take decisions to break it for violation of even less significant actions. In such cases banks will give a chance for borrower to rectify them. If he failed to do so or failed to repay it bank will liquidate the securities for loan recovery.

(g) Updating the Credit File and Periodic Follow-up

The credit officer should update the credit file of borrower continuously after granting loans. The activities in this step include,

1. Processing the loan payments and reminders have to be sent to borrowers for late payments. This facilitates the bank to minimize the credit risk.
2. Bank can ask the financial report of the borrower firm to assess it's performance and soundness to meet the debt.
3. Banks have a right to inspect borrowers activities without any notice to him.

(h) Credit Review and Monitoring

Credit review and monitoring constitute one of the important process of credit management that adds value to banks financing by reducing credit risk associated with it. Credit review and monitoring can be separated from credit analysis, executing and administration for successful banks. Credit review and monitoring is a process of continuous view of firm's debt servicing capacity and monitoring it's performance bank can monitor the performance in two ways,

(i) Monitoring the financial statements of borrower continuously and reminding them about the repayment delays and if they observed any signs of misconduct or ineffective performance.

(ii) Monitoring through external and internal audit teams either continuously or periodically. This depends on the size and importance of the credit. Credit team should identify the deficiency of loan document and other aspects and rectify them by taking proper measures.

2.4.2 Credit Management – Objectives, Significance, Problems

Q10. What is credit management? Explain its objectives and significance.

Answer :

Credit Management

The productive and profitable use of bank resources for achieving desirable economic growth is known as credit management. Credit management also ensures equal distribution among different segments for growth of economy without any barriers in the national objectives and the banking objectives. The planning, selection, analysis, budgeting, designing and implementation of schemes and plans completely relies on credit management. The credit management is linked to the management.

Objectives of Credit Management

The use of funds and their distribution is estimated by the credit management. The decision making involves a logical approach along with a wise judgement related to men and projects. The credit policy basically aims at ensuring smooth flow of funds into different sectors on the basis of their socio-economic objectives. It also aims it maximizing returns in a long-run and optimizing them during the short-run. For this purpose the alternative uses of funds and allocation of resources after the consideration of production and market inter relationships are estimated. Productive use of records, in relation to capital funds and deposits is a major concern for credit management.

The objectives of credit management and bank management are in agreement with each other,

1. Divisional distribution of credit.
2. Providing support to agriculture, industry and exports.
3. Confirming efficient utilisation of funds.
4. Profit maximisation.
5. Controlling the use of funds at the micro-level.
6. Reducing risk and guaranteeing safety.
7. Efficient flow of funds and their recovery.
8. Increasing the returns of the banks.
9. Planning credit and its control on a micro level.

Importance/Significance of Credit Management

Credit management has a direct impact on banking activities and is therefore crucial. Successful discharge of the credit function is the basic responsibility of credit management. Therefore it is considered as the management of credit function.

Selective Credit Policies

Loan rate ceilings polices and limitations on the portfolios of financial institutions constitute unexpressed subsidies or taxes. These tax may be level due to low deposit interest rates and are very complex. The interest subsidies of central bank may lead to reduction in transfer of budgets and affect the fiscal policy stance. The lending to non-priority sectors at a interest rate of less than the market rate, by banks, has an impact on resource allocation. The contingent liabilities arising from guarantees of repayments are taken over by the government thus making it the guarantor of financial system's stability. In the long-run reduction in the scope of selective credit and guaranteeing of policies and transferring the unexpressed subsidies and taxes can prove to be the solution to these problems. This enables the government to compare the cost associated with credit programmes with other budgetary expenditures along with reduction in the monetary impact of these policies.

Q11. Write about various problems associated with credit management. Describe various types of relationships existing in credit management.

Answer :

Problems of Credit Management

Following are the some of the reasons for the problems that occur in managing the credit,

(i) Lack of efficient credit culture

(ii) Poor policed asset growth

(iii) Risks associated with different borrowers.

(i) Lack of Efficient Credit Culture

Lack of efficient credit culture will provide poor criteria for assessing the debt servicing performance of borrowers by focussing more on market diversity and market share.

(ii) Poor Policed Asset Growth

Borrower's firm with inefficient growth of assets need to depend on the profits growth for repaying the loan amount. The ineffective asset growth can be determined based on dream sheets or increasing short-term debts in the accounts.

(iii) Risks Associated with Different Borrowers

(a) Large Borrowers

In case of large borrowers banks need to face high risks and difficulties. It will also leads to credit sharing. Banks are required to be defensive to recover the loans and to protect the assets from transformation into non-performing assets.

(b) Moderate-size Borrowers

In this case, there will be an increase in borrower's leverage. To avoid this, banks are required to go for venture capital partners.

(c) Small-size Borrowers

These borrowers can utilise the bank's funds as equity which leads to an increase in borrower's leverage from the initial stages. It requires proper monitoring and control for credit management.

Various Types of Relationships existing in Credit Management

In order to manage the credit, properly banks/financial institutions should maintain harmonious relationships with borrowers, and senior managers of the banks.

1. Relationships with Borrowers

Banks should have a close relationship with borrowers and also have complete knowledge about borrower's ability, credit-worthiness etc. Lenders/loan officers are opinioned that they can gain knowledge about credit only after incurring loss. The sophisticated systems of the banks implented are to educate the loan officers about the,

(i) Poor financial and management control systems.

(ii) Profit and loss of each part of business.

(iii) Mismanagement.

(iv) FAD products.

(v) Marginal products.

(vi) Behaviour of the officers.

(vii) Over-reaching.

(viii) Poor business strategy

(ix) Poor assessment of borrowers and management.

(x) Poor appraisal system to appreciate borrower firms.

They should consider the changing technology and customer preferences. Banks can build harmonious relations with customers of small size markets instead of large markets. In large market number of borrowers are more which is associated with high risks.

2. Relationships with Senior Management

It is necessary for the success of a bank/credit system, the commitment of senior management and assessment of behavioural factors.

The viability analysis include the following,

(i) Analysis of past and present financial statements.

(ii) Analysis of past and present funds flow statements.

(iii) Trend analysis.

(iv) Analysis of both short-term and long-term need for funds.

(v) Review and control measures necessary for analysing accuracy and improvements that should made in budgeting.

Banks can ensure the security of a loan using the following approaches,

(i) Pre-sanction appraisal

(ii) Post-sanction controls.

(i) Pre-sanction Appraisal

In this approach banks need to quantify the risk associated with the loan and assess the risk based on the principles suggested including,

(a) Acceptable Borrower

Bank should agree the borrower/customer as an acceptable borrower by analysing the integrity and ability of the borrower, debt servicing capacity and financial health of the borrower.

(b) Acceptable Business

Banks will consider the business as acceptable business to provide financial assistance as per the rules and regulations of government and RBI. The business should be viable and ensure the repayment with its asset and profit growth.

(c) Acceptable Purpose

Banks will grant credit either short-term or long-term by analysing the purpose of the borrowers.

(d) Acceptable Repayment Programe

Banks always try to maintain liquid portfolio by granting short-term loans with (repayment) short maturity periods.

(e) Acceptable Security

Banks should maintain security against the happening of uneven things. Security may be in terms of primary (goods) and collateral securities.

(ii) Post-sanction Controls

Outcomes of pre-sanction appraisal provides basis for post-sanction controls. Banks are said to be successful in lending, if they have selected right customer accurate appraisal system and control measures.

3. Reporting Relationships

Banks should perform an act of follow-up along with sanctions and release of funds to borrowers for successful recovery of loan. The primary objectives of follow-up mechanism are,

(i) To determine the progress of the project.

(ii) To maintain partnership relation in the project with borrowers.

In India, banks are maintained proper reporting relationship with borrowers. It requires the following reports and statements from borrowers to keep a watch on the project progress and profitability.

- Monthly production reports.
- Monthly/quarterly progress reports.
- Yearly or half-yearly statements of accounts, financial position of the firm.
- Banks go for periodical visits to borrower projects.
- Need based management information and control systems in the firm should be maintained.
- Reports from nominees on board of directors regarding the developments in operations and management.

Banks should also required to conduct formal discussions with the board of directors/sr. managers. The auditors, management and technical consultants should submit reports to the banks about periodical progress of the project in specified cases. The main objective of the follow-up mechanism and reporting relationships is to create an awareness about financial disciplines and managerial imperatives among the borrowers/promoters for successful management of the projects. These promoters are able to implement the measures suggested by banks/financial institutions at all the stages the project.

The role of banks/financial institutions is not limited only to provide financial support but also to enlighten and empower them about the management imperatives for successful management of the venture. Thus, it is said that banks/financial institutions are playing a creative and contributive role in the economical and profit growth of the industrial projects.

2.5 DIFFERENT TYPES OF LOANS AND THEIR FEATURES

Q12. Define the term loan. Explain briefly about different types of loans provided by banks and their features. *Model Paper-II, Q7(a)*

OR

Explain the different types of loans and their features.

(Refer Only Topic: Different Types of Loans)

Answer : *(May/June-13, Q3(a) | May/June-12, Q3(a))*

Concept of Loan

These include the funds available by way of loans or credit.

It usually carry a fixed rate of interest. They may be long term, medium term or short term. They usually require security of assets.

Interest must be payable half yearly or yearly without fail which is a compulsory obligation.

Lenders will not be having any right of control over management.

Long Term Loans

1. These are meant for industrial development
2. They provide medium and long term finance to industrial enterprises at reasonable rates of interest.
3. Direct loans can be obtained.
4. These institutions subscribe industrial debenture issues.
5. The important institutions are ICICI, IDBI, SFC, State Industrial Investmental Corporation etc.

Short Term Loans

The sources of short term finance are as follows,

1. **Trade Credit**
   (i) It refers to the amount payable to the suppliers of raw materials, goods etc., after an agreed period which is generally less than one year.
   (ii) With the increasing production, this also increases.
   (iii) It is a common source of finance. No special efforts are required to avail it.
   (iv) This can be adjusted to the changing needs of purchases.
   (v) Creditors often adjust the time of payment even when borrowers are unable to pay in time keeping the continuous dealings in mind.
   (vi) Sometimes company accepts the bill of exchange which is to be paid on maturity and it is a legal commitment (obligation).
2. **Bank Loans and Advances**
   (i) Money advanced or granted as loan by the commercial bank is known as bank credit.
   (ii) The most common bank credit is overdraft.
   (iii) Bank credit is the cash credit which would be obtained against security of goods and materials in stock or against personal security of directors.
   (iv) The total amount drawn should not exceed the limit fixed.
   (v) This credit amount can be adjusted according to the needs of the business.
   (vi) The rate of interest is usually a little higher but it can be compensated by profitable use of the funds in the short run.
   (vii) Commercial banks also advance money by discounting bills of exchange.

Different Types of Loans

Loans is a source of funds provided by banks to borrowers (firms/individuals) to satisfy their needs. Loans are classified into different types based on the purpose, collateral, maturity period, repayment structure and profile of borrower. They are,

(a) Working capital loans

(b) Term loans or industrial credit

(c) Loan syndication

(d) Agricultural loans

(e) Project finance

(f) Retail loans

(g) Non fund based credit.

Let us discuss each type of loan in detail below.

(a) Working Capital Loans

Working capital loans are also termed as short term loans.

For remaining answer refer Unit-II, Page No. 2.3, Q.No. 2, Topic: Short-term Loans.

Irrespective of the demand and market fluctuations firm has to maintain a constant level of working capital to meet the regular operations of the firm. Unlike fixed assets permanent current assets can be replaced in future or realised into cash. The difference between minimum level of current assets and current liabilities excluding bond debt and installments represents the permanent working capital requirements. Banks will fund the permanent working capital needs of a firm either by providing long term debts or short term debts. The latter will be in cases of substantial growth in sales.

The loan repayment structure should be in line the with the working capital cycle similary the terms of debt are in such a way that it should minimize the risks associated with the credit.

Banks should estimate the working capital needs exactly. Over or under estimation of the working capital needs is associated with risks and leads to loss to both bank and borrowers.

(i) Over estimation will make the borrower not to utilise the funds properly and also facilitate him to purchase non liquifiable assets.

(ii) Underestimation of the needs may leads to face a temporary cash crunch in the borrower's firm or they may request for additional loans or get loans from other sources at very high rates.

(b) Industrial Credit or Term Loans

For answer refer Unit-II, Page No. 2.3, Q.No. 2, Topic: Long-term Loans.

(c) Syndicated Loans

Banks will provide loans to large projects through syndication. Loan syndication is polling of funds from two or more banks by grouping them for funding large projects. This is because funding large projects involve high credit risk and capital limitations syndicated loans can mitigate the market and credit risks associated with the projects by sharing it with the participated banks and also to satisfy high capital requirements of borrowing firm. The features of syndicated loans is a combination of relationship lending and public traded debt.

Syndicated loans are mostly offered to international firms. There has been observed a shift towards these loans with an increase in privatisation across the world. There is a decrease in loan syndication during 2007 whereas it has been slightly growing since 2009. The participants in loan syndication are called creditors categorized into two groups, senior syndicate member and junior banks.

Senior syndicate members manage the syndication/ funds pooling and other participants. They act as mandated arrangers, arrangers, lending managers or agents. Borrower need to select the senior banks for syndication as per the terms mentioned in agreement.

Managers and participant titles constitute the second group of creditors size, complexity, price of the loan and borrowers interest determines the number of participants. Senior creditor play a key role in taking decisions regarding the participants contribution to loan syndication, negotiations and loan administration. Senior banks will be paid fee for processing along with high profits whereas junior banks gain only profits. However junior banks can gain identity and other profitable opportunities in future through their participation in syndicated loans.

Fee in syndicated loans include arrangement fee legal fee, underwriting fee, facility fee, participation fee, committee fee, utilisation fee, agency fee, conduct fee, and payment fee.

(d) Agricultural Loans

These loans are provided by banks to agriculture sector and other related firms. The features of these loans that are similar with other loans are,

(i) Agricultural loans are either short term or long term. Mostly, they are short term loans and sometimes they are long term loans for purchasing land, equipment or livestock.

(ii) These loans are effected by seasonal fluctuations as that of seasonal industries.

(iii) Like working capital loans, agricultural loans are also used to meet working capital needs such as inventory, seeds, fertilizers etc.

(iv) Cash can be realised from the sale of crops after harvesting them at the end the season.

As agriculture is considered as a major sector in most of the countries it occupies the highest national priority. Government and banks provide their support to agriculture and other allied activities in from of loans.

These loans are associated with high risk as they are effected by seasonal fluctuations. Banks have to assess the agricultural loan same as that of other loans in all aspects except for returns.

(e) Project Finance

Project finance is an asset based lending. The loans provided for investing in a project are called project finance. Capital/Equity, and limited recourse debt will be provided by the one or more sponsors for carrying out the project.

The processing of project finance is time and cost consuming process. It involves the feeds to lawyers, consultants and advisors along with processing, committee fees etc. It takes 5-7 years for structuring the loan after completing all formalities and clearance by considering the relations of borrowing firm with the construction companies, suppliers, purchasers, operating companies and other partners.

Major portion i.e., 70% of the capital requirement will be provided by the banks in terms of project finance where as the remaining will be the owner's shareholder's equity or project recourse. Banks offer project finance through debt, syndication, subscription of bond issues etc.

Project finance is associated with high risks and limited recourse to sponsors. Bank will provide finance in terms of loans after assessing the risk and returns whereas credit officer need to give suitable measures for minimising risk associated with it.

(f) Retail Lending

Banks will also provide loans to individual customers which are termed as retail loans. These loans are to serve the purposes of buying a house, car, land, education, medical care etc.,

(i) The size of retail loans is smaller when compared to corporate loans and the maturity period is 1-5 years. sometime more than 5 years (Example: Housing loans)

(ii) The interest rates are fixed for retail loans and the borrower should repay the loan amount in equal installments.

(iii) Retail loans are also associated with default risk like corporate loans. Thus banks charge high interest rate to compensate the loss.

Retail loans are further categorised into three types.

1. Installment Loans

These are a type of retial loans that have a fixed schedule for repayment. Borrowers need to repay both principal and interest for every period.

2. Credit Cards

The repayment structure for credit cards differ with the amount that borrowers utilised.

3. Non-installment Loans

These loans are provided to meet special conditions. Borrowers can repay the amount when he is able to generate large cash flows.

Example

Bridge loan: In this a household can repay the loan granted for purchasing a house by selling the old house.

Now-a-days there has been an increase in the retail loans by banks in order to gain more profits, to mitigate risk and to enhance liquidity position of the bank.

(g) Non-Fund Based Credit

Along with fund based services banks also provide non-fund based services such as LCs and BGs/LGs (litter of credit and litter of Guarantees). In these services, there is no cash outlay to borrowers from the bank. Bank will act as a security on behalf of the borrowers to a counterparty. Like other services, these services also include risk as the bank has the liability to pay the amount to counterparty in case of borrower's failed to repay it. Bank has to pay the agreed amount as per the statue and then take legal actions on the borrowers to compensate the loss.

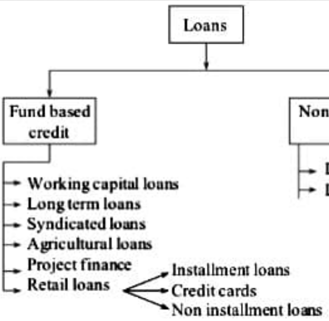


Figure: Types of Loans

Q13. Explain in detail about the loans for working of capital, capital expenditure and industrial credit.

Answer :

Loans for Working Capital

The banks provide loan for working capital to firms of both sizes i.e., large and small. The banks have expertised in lending short-term working capital finds.

The banks provide working capital loan on the basis of the firm's Net Working Capital (NWC). The net working capital is the difference between the firm's current assets and current liabilities. A positive working capital is the indication of a healthy liquidity of the firm whereas the negative working capital indicates poor liquidity of the firm. The liquidity indicates the firm's ability to pay off its creditors and is therefore, crucial for lending working capital loan.

Investment of cash in current assets is the beginning of every business. The manufacturing firms are to invest in the raw materials which are converted into finished goods and than sold in the market. The retail firms are to invest in merchandize required in the showroom and the service firms invest cash in operations and office supplies. Every firm provides credit sales to ensure growth. Therefore, the realisation of cash takes time and in order to continue operations the firm requires cash. Thus the firm opts for working capital loan.

Every business relies on proper financing methods to encourage investment and growth. Trade credit can also be a dependent factor, for firms, for financing current assets. However, the bank debt is a major dependent factor for most of the firms and is the major source of funding working capital.

The amount of working capital loan to be granted completely depends upon the nets working capital of the firm or the working capital gap. The working capital gap indicates the amount of cash required by the borrower to continue his operations, including the sources of funds available to the business, often referred to as spontaneous liabilities. 'The borrower should than introduce his fund to cover the gap which is known as margin. The bank than lend the difference amount between the working capital gap and the margin.

The unexpected demand, change in market conditions result in fluctuations in working capital requirements of the firms.

The working capital loan is granted against inventories or book debts or credit limits of the bills. The loan price relies on additional collateral securities available the credit score rating of the borrower.

Loans for Capital Expenditure and Industrial Credit

Periodical investment in capital assets is required for the expansion, modernization or diversification of business. The credit required for such purposes extends the limit of one year. Therefore, term loans are acquired for this purpose. Term loans are granted to increase the working capital permanently or purchase of new assets. The maturity term for these loans varies between 1-7 years. Long maturity periods are more likely to result in liquidity problem in banks and are therefore mostly avoided.

The long-term cash generation ability of the borrower is analysed before granting long-term long. The banker takes a collatesal for long term lending as a secondary source of repayment.

The usage of loan amount determines the term loans characteristics. The loan amount is the difference between the actual cost of the asset and the margin amount. The interest rate is fixed on the basis of bank's perception of risk of the borrower and the collateral liquidation value over the duration of loan.

The term loan repayments and interest payments are set in the following ways:

- Repayments in fully amortized equal annual half yearly/quarterly installment. The borrower pays the interest and principal in varying amounts. The repayment of principal amount results in calculation of interest rate on the remaining principal amount.
- Repayment of principal amount over a specified period of time in equal installments. The interest is separately calculated or the reducing balances. The debt service also differs from one period to another.
- Balloon repayment method may also be followed. In this repayment method the borrower only pays the interest amount and the principal amount is paid in full upon maturity.
- In some rare cases the principal and interest amount are gradually paid for a period of 25 to 30 years and the remaining principal amount is paid in full upon maturity.
- In case of projects or construction loans the repayment is done upon the basis of program of the project or construction.

Q14. Explain in detail about the loans for syndication and loans for agriculture.

Answer :

Loans Syndication

Huge amount of funds are required for large projects. A single bank would not be able to meet the fund requirements for such projects. Therefore, loan syndication is required, which would enable the bank to meet the loan requirements of the borrower and also earn a fee income. This ensures less credit risk and earning of non-interest income.

The loans granted to a borrower by a group of banks is known as syndicated loans. They divide the credit risk among different financial institutions and possess the combined features of relationship lending and publicly traded debt.

Such loans are international financing's most crucial source. Syndicated loans are on third position in international accounting. Increasing changes in privatization in the emerging markets has enabled banks, utilities and transportation and mining companies to borrow syndicated loans from different regions. The syndicated loan facilities experinced a down fall during the year 2007. During the second and third quarters of 2009 a slight increase was being experienced.

Under syndicated loan two or three banks mutually agrees to jointly grant loan to a borrower there is a single loan agreement which includes a separate claim for every syndicate member. The creditors are divided into two groups namely the first group consists of senior syndicate banks and the second group consists of the junior banks. The senior group is led by one or several leaders and is appointed by the borrower. This group includes only the senior members. Whereas the junior group includes bearing manager or participant titles. The size, complexity and price of loan determines the members belonging to the junior group.

The junior banks only earn margin and on fees. But the junior banks usually participate in such loans so as to cut down their origination costs. Relationship building and a hope that borrower may reward them with a greater opportunity are also the reasons for junior banks to become the members of syndicated loan.

The lead bankers usually take a major share in the credit exposure however it is not mandatory. But their participation indicates their reliability on the borrower's credit worthiness.

The arrangers face the risk of syndication as well as the major share in syndicate's credit exposure.

Therefore the relationship bank must conduct a thorough research of the project and its prospects before binding on becoming a mandate.

Loans for Agriculture

The loan for agriculture is very much similar to other types of loans. The following are the similarities between loan for agriculture and other loans,

- The loans for agriculture are mostly short-term loans.
- The norms of seasonal industries are applied as the agriculture is seasonal.
- They are similar to working capital loan as the loan is required for purchase of inventory i.e., seeds, fertilizers. etc.
- The sale of harvested crop in the market results in realization of sales.
- Investment in land, equipment or livestock are granted long-term agricultural loan.
- The cash flow generated from sale of harvested crop or livestock is used for loan payments.

The national priority of agriculture in most developed and developing countries is the major difference between agricultural loan service and other loan service. The governments have introduced policies to ensure the grant of loans to these sectors even if they are to incur losses for a specific period.

Eventhough loan for agriculture is similar to other loans yet it is treated differently. Most countries have introduced policies and framework that ensure support to agriculture by banks.

Q15. Loans for infrastructure, loans to consumers and non-fund based credit are the different types of loans. Explain.

Answer :

Loans for Infrastructure- (Project Finance)

Loan for infrastructure is an important type of asset based lending. A legally independent project company having as equity from one or more sponsoring firms and no or limited resource debt are all created by the project finance in order to invest in a single purpose industrial asset.

Structuring a project finance deal includes various transaction costs such as the lawyers fees consultants fees and financial advisors fees the be sides acquiring the environmental clearances and the necessary permits fees. Usually 5-7 years are needed for structuring the deal as these deals includes finding out and entering into contracts with construction companies of equipment and input suppliers, output purchasers, operating companies and tying up financing with capital providers. The project companies have a mean debt of 70 percent and possess a highly leveraged structure. The project recourse is the term given to the debt, as its services completely relies upon the cash flows of the project.

The debt, syndicated loans or subscription to bonds of project companies forms the major source of project finance from banks. Various credit arrangements are being made in order to finance the project as the amount of risk is higher.

The term loans are the basic source of credit delivery. The approval of credit is the major challenge, as the credit officer needs to understand the project and risk in detail and then institute the appropriate risk mitigation actions in order to assures the timely debt services.

Loans To Consumers or Retail Lending

The consumers usually borrows loans in order to purchase durable goods meet education, medical care, housing and other expenses. The amount of loan granted to consumer is relatively less when compared to the amount granted to that of businesses. The maturity period usually lies between 1-5 years. However, it may be longest in case of housing loans. The rate of interest is fixed and principal amount is to be paid in equal installments. The consumers loans are more unreliable than the corporate borrowers and therefore holds a higher rate of interest. But the rate of risk in case of individual borrower is less when compared to the corporate borrowers.

The consumer loans are divided into three-installment loans, credit cards and non-installment loans. In case of installment loan, a fixed repayment schedule is made and it involves repayment of both interest and principal amount periodically. In case of credit cards the payments and made in accordance with the amount used whereas in case of non-installment loans the amount is paid-off in a single repayment.

Retail lending is being increasingly practiced by banks is order to increase the consumer spending capacity eliminate the default risk and ensure greater liquidity to banks which would further increase the enhanced profits.

Non-Fund Based Credit

The non-fund based credit limits are being provided/ given in order to ensure smooth flow of borrower's business. LCs and BGs are the two common forms of non-fund based credit. These funds are usually referred as non-fund based as there is absence of funds outlay at the time of granting the facility. The income from such services are recorded under non-interest income.

Eventhough this credit does not result in any immediate payout of funds but it still involves credit risk. These are off balance sheet exposures but are equally or more risky than that of the balance sheet exposure. The failure of the applicant to pay would result in payment by the bank to the beneficiary or counter party. The bank would be supposed to pay the amount agreed upon by the applicant or borrower. The bank itself is responsible to recover the loan from the borrower.

Therefore the banks should follow similar steps in order to accept the request for non-fund based credit, as in case of fund based credits. However, the borrower's default risk always exists.

2.6 LOAN PRICING

2.6.1 Loan Pricing - Concepts, Principles and Issues

Q16. Explain the concept of loan pricing. Discuss briefly about the principles and issues of loan pricing.

Answer :

Loan Pricing

Earlier, banks were operated in an environment with regulations in terms of interest rates. Later the scenario has changed to deregulated environment with cut throat competition among the players in banking sector. To sustain in the price competition, banks are required to price their products/services by considering both profits and risk-return trade-offs. Banks should monitor and control their revenues and costs at the times of interest rate reductions.

For better pricing, banks should compare the loan pricing with product pricing. Like product pricing, loan pricing also considers the variable and fixed costs i.e., variable costs include costs of liabilities, whereas fixed costs include servicing costs and overheads for maintenance of accounts. Banks are also required to include profit margin in the price of the product or service. The loan pricing differs from product pricing in the following two ways,

(i) Loan pricing considers the quantification of risk while pricing.

(ii) Loan pricing relies upon the customer ability to generate profits to bank. It is also called "relationship pricing".

Unlike product pricing, loan pricing is a complex process and also non-standardized one. The components of loan price are,

(a) Cost of funds

(b) Servicing costs

(c) Risk premium (RP)

(d) Desired profit margin.

Loan price = Cost of funds + Servicing costs + RP + Desired – Profit margin

Principles of Loan Pricing

Banks should follow the principles mentioned below while pricing the loans,

(i) Banks should fix the lending rates based on the ratings given to borrowers. While granting loans to SME's the price of loan should depend on the internal risk rating framework of the bank.

(ii) Bank should fix the lending rates on loans. They charge high rates for loans associated with high risks and low rates for those with the least risk. In general, banks price the loans with medium risk based on the policies and practices followed.

(iii) The factors that affect the loan price include degree of credit loss, capital resources to meet credit risk and expected returns on capital.

(iv) Cost of funds, term of loans and repricing interval also effect the rate of interest on loans as the uncertainties incur additional costs.

(v) While pricing, banks should rate the risks involved and accordingly determine the probability of default and loss.

(vi) Borrowers should pay penalty under penalty clause for prepayment of loans and least utilization of the granted credit.

Issues of Loan Pricing

Pricing of loans is associated with number of issues which include,

(i) Criteria for rating the risk profile of customers.

(ii) Decisions on type of loans.

(iii) The range of prime rate quotations.

(iv) Changes in loan prices for attracting customers.

(v) Adjusting the fee income in loan price.

(vi) Basis for quotation of price

(vii) Changes in price according to the changing customer relationships.

All these issues can be resolved effectively using customer profitability analysis model for pricing the loans. The primary issue here is the framework for reconciliation of the decisions related to deposits, loan portfolio and profitability of the bank with decisions related to pricing the loans.

2.6.2 The Basic Model of Loan Pricing

Q17. Explain briefly about the general/basic model for pricing bank loans.

Answer :

Basic Model for Loan Pricing

The basic model provides the general procedure for pricing the loans. The steps involved in the basic model include,

(i) Determination of cost of funds

(ii) Determination of servicing cost for each customer

(iii) Default risk assessment and enforcing securities

(iv) Fixation of profit margin.

(i) Determination of Cost of Funds

The first step in loan pricing is to assess the cost of funds. Banks should determine whether the variable costs are included in the loan price. The cost of funds are either the average cost of bank's sources or the bank sources for lending loans/credit to borrower. Cost of funds of a bank can be determined by analyzing the investment policy of the bank, which plays a very important role in determining the profitability of the bank in a loan transaction.

Loan price = Cost of funds + Desired profit margin

(ii) Determination of Servicing Costs for each Customer

Bank should analyse the following aspects in order to determine the service costs,

1. List out all the services offered to customers consisting of both credit and non-credit services. Credit services include loans, financial support to borrowers etc., non-credit services include custodial services, payment transfers, LC's etc.

2. Evaluate the costs for each service by determining the cost accounting system followed by the bank.

3. Determine the total cost for each customer by multiplying the unit cost/service with the number of times the customer utilizes the non-credit services.

Example

If the unit cost/service is ₹ 20/- and the customer utilized it for 600 times, then the total servicing cost for that customer would be,

20 × 600 = ₹ 12,000/-

4. In case of credit services, the cost depends on the size of the loan and constitutes substantially a greater part of the total service costs. These costs include costs for loan administration delivery costs etc.

(iii) Default Risk Assessment and Enforcing Securities

Bank should assess the default risk associated with the credit services which are being offered. Credit scoring system is an effective method to assess the risk by analyzing the various criteria for risk classification. In this method the rating of the borrower would help the bank in taking decisions regarding the loan grants and also for rating the risks associated with it. Banks are also required to determine the probability of default and rate the securities which are held by assessing the borrowers with similar risk profiles. This forms the basis for determining the probability of loss associated within.

The bank can calculate the best risk premium by determining the probability of loan and interest recovery. Bank can receive expected rate from the borrower if the loan transactions have 'O' probability of default.

Expected rate is given by,

[Probability of recovery × Contracted rate] + [Prob of default × Irrecoverable advance]

Mathematically,

$$\boxed{E(r) = P(R) + P(D) \times \left\{\left[\frac{R(P+Pr)}{P}\right] - 1\right\}}$$

Where,

$E(r)$ = The expected rate

$P(R)$ = The probability of recovery

$P(D)$ = The probability of default

r = The contracted rate of interest

R = The recovery rate

P = The principal amount

(iv) Fixation of Profit Margin

Banks can fix the profit margin on the basis of ROE. ROE can be determined by multiplying ROA (net returns on assets) with (equity multiplier) EM.

$$\boxed{ROE = ROA \times EM}$$

ROE is mostly affected by market expectations and shareholders returns. ROA is the product of ROE and inverse of EM i.e., equity/assets. ROA indicates the capital adequacy of the bank in meeting the costs of liabilities.

All these steps must be followed for pricing the loan including a profit margin. Banks are required to adjust the risk premium and profit margin according to the changing customer relationships.

2.6.3 Procedure for Pricing Fixed and Floating Rate Loans

Q18. Explain briefly the procedure for pricing fixed and floating rate loans.

Answer :

Banks will charge fixed rate of interest if there exists stability in interest rates and upward movement of yield curve. Contrarily banks charge floating rates if the interest rates are volatile. In this case banks are required to grant short term loans. Floating rates are more profitable for banks, as they can carry the interest rate risk to borrower from the bank but increases the credit risk for bank. Most of the banks are encouraging their customers to offer floating loans as they facilitate the profitability of banks by increasing the burden of interest to borrower.

Fixed rate loans are profitable for borrowers, as they transfer the interest rate risk to bank and borrower can meet the debt by predictable cash flows. The alternative ways that are provided by banks for improving the floating loans are,

1. Banks provide loans with a floating rate less than fixed rate and charge a "term premium" to compensate the interest rate risk and credit risk.

2. Banks offer an interest rate cap either for a particular time period or for whole term of loan to rise the interest payments from borrowers.

Banks can generate more profits by aligning the floating rates with the benchmark rates such as LIBOR and prime rate.

1. Pricing Floating Loans

Prime-rate based pricing models can be used for pricing floating loans. In exceptional cases they can use sub prime lending i.e., lending below the prime rate. Banks often use a prime rate as basis and mark above or below this rate to suit the conditions. The interest rate changes with the changing prime rates accordingly. The interest rates are determined by assessing the creditworthiness of borrower and structured to minimize the risks associated with it.

In general, banks use either of the methods for marking the price.

(a) Prime plus or additive method

(b) Prime times or multiplicative method.

(a) Prime Plus Method

In this method, if a borrower is required to pay a premium of above the prime rate, then the price can be represented as "prime + x".

x is the premium above the prime rate.

Example

If a borrower need to pay a premium of 500 bps over prime rate and if the present rate is 10%, then the price is given as "prime + 5" i.e., 10+5. 500 bps represents the creditworthiness of borrower to repay the loan.

If the rate of risk is high, then there will be an increase in the additive factor.

Example

If the premium is increased by 200 bps means prime rate is 10 + 2 = 12%.

$\therefore$ Loan price = 12 + 5 $\Rightarrow$ 17

If the premium is decreased by 200 bps means prime rate becomes 10 – 2=8%

$\therefore$ Loan price = 8 + 5 $\Rightarrow$ 13

(b) Prime Times Method

In this method, multiplicative factor is used to find the loan price and prime rate. The increase in multiplicative factor represents the degree of credit risk involved. A loan is priced below the prime rate if the multiplicative factor is less than unity. If it is more than one then loan is to be priced above the prime rate.

Example

If the present prime rate is 10% and the desired premium is 500 bps, the adjusting factor is determined as,

$\frac{15}{10}$ = 1.5 consider the above two conditions,

(i) Increase in prime rate by 200 bps then the present rate would be 12,

$\therefore$ Loan price = 12 × 1.5 = 18

(ii) Decrease in prime rate by 200 bps then the present rate would be 8,

$\therefore$ Loan price = 8 × 1.5 = 12

In case of high interest rates by using prime times method, banks can gain high profits whereas in case of low interest rates banks can earn huge profits by using prime plus method of pricing.

Hedging and Matched Funding

In general, fixed rate loans offer more benefits to borrowers than floating loans. Mostly banks use interest rate volatility for compensating the loss of profits due to fixed rate loans. The methods used to increase the volatility of interest rates are,

(a) Interest rate swaps

(b) Futures

(c) Matched funding.

(a) Interest Rate Swaps

Borrowers will exchange the fixed rate payments with the floating rate receipts or by buying interest rate caps.

(b) Futures

Banks can reduce the loss of profits by selling the futures or purchasing put options for futures.

(c) Matched Funding

In this method banks can reduce the interest rate risk by matching the loans with deposits of same maturity periods.

Example

If a bank is required to grant a loan for two years, it will source the funds for loan from the deposits with the same maturity period and interest rates. Transfer pricing system can also be used for matched funding.

2. Pricing of Fixed Rate Loan

A fixed or constant interest rate is charged on the loan amount under fixed rate loan. The demand for fixed rate loans increases when the interest rates are expected to rise. The interest rate futures may be used to convert a fixed rate loan into as floating rate loan.

Banks offer fixed rate loan when there is stability in interest rates. The borrowers prefer fixed rate loan as the cash flows are predictable and the interest rate risk is transferred to the bank. In order to overcome this risk the banks charge term premium on fixed rate loans. The amount of premium is decided on the basis of cost of funds and required rate of return of the bank.

Q19. Write in detail about the following,

(a) Hedging and matched funding

(b) Price leadership model.

Answer :

(a) Hedging and Matched Funding

For answer refer Unit-II, Page No. 2.21, Q.No. 18, Topic: Hedging and Matched Funding.

(b) Price Leadership Model

The basic model assumes that the bank knows its costs accurately and therefore the chances of default and recovery rate of each borrower can be determined. But in the real world, this is not possible. Today, the tracking and allocating of costs is very difficult, as the lenders deal with different multi products. The basic model does not indicate the impact of increased competition on the profit margin. Due to these reasons, the price leadership model has been introduced in the banking sector. Under this a base or reference rate is established by the bank and the interest rate for loan is the base plus the mark up price that indemnifies the amount of risk. The credit scoring system is used by most of the banks for assessing the risk premium. The loan interest rate can be expressed in the following formula,

Loan interest rate = Base or prime rate + Default risk premium + Term-risk premium

Let us assume the following example

A firm asking for a loan for three years for purchase of equipments. The loan rate is said to constitute of 6 percent prime rate, 2 percent default risk premium and 3 percent term risk premium. Therefore, the loan rate is,

Loan interest rate = Prime rate + Default risk premium + Term-risk premium

= 6+2+3

= 11 percent per annum.

2.6.4 Cost - Benefit Loan Pricing Model

Q20. Discuss briefly about the "cost-benefit pricing model" with an illustration. Write about the other models used for pricing loans.

Answer :

Cost-Benefit Pricing Model

In cost-benefit loan pricing model, banks often price their loans based on the standard base rate such as London Inter Bank offered Rate (LIBOR) and prime rate. The loan price is in such a way that it should cover all the costs and risks associated with the credit transfer. For effective pricing, banks use highly developed pricing systems in order to analyse the risks and returns involved in.

Steps Involved in Cost-Benefit Pricing Model

(i) Estimate the revenues generated by the loan grant using sensitivity analysis method at different interest rates.

Estimated revenues = Revenues from utilized credit limit +Revenues from unutilized credit limit

(ii) Calculate the turnover of net funds to banks.

Net funds turnover = Utilized funds – [Compensating balance + Reserve requirement]

(iii) Determine the profits before tax generated from the loan grants using the following formula,

$$\text{Profits before tax} = \frac{\text{Estimated revenues}}{\text{Net funds turnover}}$$

Example

If a bank granted ₹ 5 crore credit limit to a borrower but he utilized only 4 crores at a rate of 25%. The committee fee is 1% on the ensued credit. Borrower should maintain a deposit of 20% of utilized credit and 5% of unutilized credit. Reserves should be maintained at a rate of 12% on the deposits.

Solution :

(a) Estimated revenues from loans = Revenues from utilized credit + Revenues from unutilised credit

= (4 crores × 0.25) + (1 crore × 0.01)

= 1 crore + 1 lakh

= 1.01 crore.

(b) Estimated bank funds = Utilized credit – [Compensating balance + Reserves requirement]

= 4 crores –[4 × 0.2 + 1 × 0.05] + 0.12 [4 × 0.2 + 1 × 0.05]

= 4 – [0.85+0.12(0.85)]

= 4 – 0.952

= 3.048 crores

(c) Profit before tax generated from loan to bank $= \frac{\text{Estimated revenue}}{\text{Net funds turnover}}$

$= \frac{1.01}{3.048} = 0.33$

= 33%

Based on these estimated profits before tax bank can decide on the loan price whether the profits are adequate to meet all the costs and liabilities.

Other Models

Other models proposed to price the loan include price leadership model and customer profitability analysis.

(a) Price Leadership Model

The basic model that is proposed to price the loans failed to generate profits in presence of intense competition among the players. The pricing of loans in a competitive and dynamic environment can be better explained by using price leadership model. In this model banks will set a base rate. Earlier this rate was very low to attract more customers but now banks are adding mark up price to the base rate in order to generate profits even in risk conditions. Often banks use credit scoring system for rating the risks associated with credit as the risk premium is a key factor in pricing the loan.

(b) Customer Profitability Analysis

For answer refer Unit-II, Page No. 2.23, Q.No. 22.

Q21. Explain the basic model of loan pricing. Also write about cost-benefit loan pricing.

Answer : *(Model Paper-I, Q7(b) | May/June-17, Q3(a))*

Basic Model for Loan Pricing

For answer refer Unit-II, Page No. 2.19, Q.No. 17.

Cost-Benefit Loan Pricing

For answer refer Unit-II, Page No. 2.22, Q.No. 20.

2.7 CUSTOMER PROFITABILITY ANALYSIS

Q22. What is customer profitability analysis? Write down the different steps of analyzing customer profitability.

Answer :

CPA

The development of more detailed information system for tracking of costs by lenders has led to the introduction of Customer Profitability Analysis (CPA) technique for loan pricing. This technique is very much similar to the cost-plus pricing technique. According to this technique the revenues and expenses of a customer are taken into consideration for pricing of a loan. The CPA is calculated using the following formula,

$$\text{Net before tax rate of return to the lender} = \frac{\text{Revenue provide to the customer} - \text{Expenses of facilitating loans and other services to customer}}{\text{Excess of lonable funds used in customer's deposits}}$$

Steps Involved in Analyzation of Customer Profitability

The following steps are followed for analysing customer profitability,

Step 1: Identification of Services

The first step is to identify the various services being used by the customer. These services include deposit services, loans taken, payment services, services of transfer of funds, custodial services, and other fee-based services.

Step 2: Identification of each Service Cost

Once the services availed by the customer has been decided, the next step is the identification of cost of each service provided. The bank's cost accounting system provides the details of every unit cost incurred by the customer. The services of banks are divided into two categories, namely credit-related and noncredit related services.

Step 3: Identification of Cost of Non-credit Related Services

In this step, the total cost related to non-credit services is calculated. This calculation is done by multiplying the unit cost with activity level of each service.

Step 4: Identification of Cost of Credit-related Services

The credit-related services constitute a major portion of total costs. The credit related cost refers to the actual cash expenses incurred by the bank in the form of interest payment for loan sources, cost of credit analysis and execution. The other credit related costs are the overhead costs which include payments for bills sent for collection, processing of payment maintaining collateral and updating documentation. Fixed percentage of the loan amount can be used for its computation.

Step 5: Identification of Default Risk

Every bank loan includes a specific amount of risk. This is known as default risk expense. The rating system of bank's categorises loans on the basis of their default risk component and the chances of their occurrence. The default risk is sometimes directly included into the bank loan by the banks.

Step 6: Assessment of Revenue Original from Customer Deposit

In this step, the revenue generated as a result of relationship with the customer is assessed. The customer keeps the deposits with the bank and the income from these interest-bearing deposits is calculated by deducting the average transaction float and the mandatory reserve requirements. The basic interest rate is then applied to the balance to calculate the actual revenue generated through consumer's deposit balances Varying interest rate levels result in different amounts of opportunity cost of compensating balances.

Step 7: Assessment for Fee-based Income Originated

Once the revenue generated from customer deposits is assessed the next step to is assess the income generated in fee-based form. The banks charge fee for various services provided. In credit relationships fees is charged on processing of loan application and making of funds available, commitment fees is charged on credit limit's unused portion and converting fee is charged for rescheduling of loan repayment terms, by the banks.

Step 8: Assessment of Earning from Loans

This is the last step in the process of analysing customer profitability. In this step, the earnings generated from loans is assessed by the bank.

Q23. Support the concept of Customer Profitability Analysis (CPA) with an example.

Answer : *Model Paper-III, Q7(a)*

Customer Profitability Index

For answer refer Unit-II, Page No. 2.23, Q.No. 22.

Example

Let us assume the following example. A bank is planning to grant a loan of ₹ 30 lakhs for a period of six months to ABC Ltd. an oil company. ABC Ltd. utilizes full amount of credit and maintains a deposit of 20 percent of the credit line with the bank. The following are the expected revenues and expenses.

Sources of Revenue Expected from the Customer	
Income from Interest (12% six months) on loan	₹ 1,80,000
Loan commitment fees (1%)	30,000
Fees for managing deposits	90,000
Charges for fund transfer	10,000
Trust maintenance and record maintaining fees	1,22,000
Total annualized revenues	₹ 4,32,000

Costs to be incurred on Customer Savings	
Interest on deposit paid to customer (10%)	₹ 30,000
Funds raised for payment to customer	1,60,000
Cost of activities in customer's account	50,000
Cost of funds transferred to customer's account	2,000
Cost incurred on loan processing	6,000
Cost incurred on record keeping	2,000
Total annualized expenses	₹ 2,50,000

Amount of Bank Reserves to be with Drawn by the Customer During the Year	
Amount of average credit granted to customer	₹ 30,00,000
Less: Average deposits balance of customer	5,40,000
Net loanable reserves committed to customer	₹ 24,60,000

$$\text{Return on costs before tax from lender-customer relationship} = \frac{\text{Revenue expected} - \text{Cost expected}}{\text{Net loanable reserves to customers}}$$

$$= \frac{₹4,32,000 - ₹2,50,000}{24,60,000}$$

$$= 0.074 \text{ or } 7.4\%$$

Interpretation

Since, the entire lender-customer relationship indicates a positive net rate of return, the proposed loan is acceptable and all the expenses can be met. In case of negative net rate of return the proposed loan would be rejected. The higher the amount of risk the higher is the expected net rate of return by the lender.

Earnings Credit for Customer Deposits

The lenders usually give credit to the customer credit for earnings earned by investing the balance of customer deposit account into earning assets. Using customer's full amount for calculation of these earnings is inappropriate. Therefore, the net investable funds and amount of earnings to the customer are calculated as follows,

Net investable funds = Average deposit of customer – Average float amount in account

– (Required legal reserves behind the deposit × Net amount of funds collected in the account)

Earnings credited to the customer = Rate of annual earnings × Number of months funds are available for deposits × Net usable funds.

Example

A customer deposits an average of ₹ 10,00,000 this month. Float of uncollected funds is ₹ 1,000 yielding collectable funds of ₹ 9,00,000 the legal reserve requirement is 10%. The bank has decided to grant a credit to the customer at an annual interest return from using customer's deposit equal to an average of 90-day treasury bill rate which is 7 percent.

Solution :

Net investable funds = ₹ 10,00,000 – ₹ 1,00,000 – (0.1 × 9,00,000) = ₹ 8,10,000

$$\text{Amount of earnings credit to customer} = 7\% \times \frac{1}{12} \times ₹\,8,10,000 = ₹\,4,725$$

Therefore, the revenue earned from customer credit is ₹ 4,725.

2.8 NPA's – CONCEPT OF GROSS AND NET NPA's, FEATURES AND CLASSIFICATION

Q24. What do you mean by (NPA's) Non Performance Assets? Briefly explain the features and classification of NPA's and the provisions that should be maintained for each category.

Answer : *Model Paper-III, Q7(b)*

NPA – Features

A loan or asset is said to be Non Performance Assets (NPA), if it remains due for over a period of 1.80 days. The following are the features of a loan to be considered as a non performing asset,

(i) If the interest rate or principal amount is not received over a period of 90 days.

(ii) If the overdraft or cash credit of an account remains 'out of order'.

(iii) If the purchase/discounted bills remain overdue for a period of 90 days.

(iv) If the loan repayment is overdue for more than two crop seasons, in case of loan grants for short-term crops.

(v) If the loan repayment is overdue for next crop seasons, in case of loan grants for long-term crops.

(vi) If the securitization process is delayed for a period of more than 90 days.

(vii) If the derivative contracts remain overdue for a period of more than 90 days.

In general bank can consider an asset as non performing asset, if they failed to recollect the interest amount or principal installments from the borrowers within a period of 90 days from the given date.

Classification of NPA's

NPA's are categorized into three groups based on the overdue period and the ability to realize the dues. They are,

(a) Sub-standard assets

(b) Doubtful assets

(c) Loss assets.

(a) Sub-standard Assets

Sub-standard assets are a type of NPA's that remain due for a period of less than or equal to 12 months.

Features

A loan can be considered as a sub-standard asset if,

(i) The security provided by borrower or guarantee is not sufficient to recover the loan amount.

(ii) The asset is ineffective to repay the loan and it is not able to liquidate the asset for loan recovery.

(iii) The deficiencies are not corrected properly, bank will definitely incur loss.

Provisions

For sub-standard assets bank should provide 10% provision on outstanding balance and an additional provision of 10% for an unsecured exposure. Total 20% provisions should be maintained. In case of securities containing intangible assets, bank should treat the advances as "unsecured".

(b) Doubtful Assets

The assets that can be considered as doubtful assets, if they remain overdue for a period of more than 12 months in the category of substandard assets.

Features

A loan is considered as doubtful asset if it has following features,

1. Doubtful assets do not be credit worthy to repay the loan by liquidation.

2. The values and conditions become unrealistic in case of doubtful assets.

Provisions

For doubtful assets bank should maintain 100% provision to recover the advances, that cannot be recovered from the securitization transactions. For these assets that can be recovered from securitization, bank should maintain a provision from 20% to 100% on the basis of the following,

Till one year	20%
1-3 years	30%
$\geq$ 3 years	100%

(c) Loss Assets

The assets, that can be considered as loss assets if it is not possible to recover the loan even though it has some salvage value. RBI inspectors, internal and external auditors of a bank will classify the assets into loss assets but they do not completely write off the amount in accounts/books.

Provisions

For loss assets, bank should maintain 100% provisions and need to be written off completely for all provisions.

Banks should also maintain provisions such as general provisions, floating provisions.

(i) General Provisions

Bank should maintain a general provision for standard assets. The general provision ranges between 0.4% - 1% on standard assets. Provisions on standard assets cannot be deducted for computing net NPA's as these are considered as contingent provisions mentioned under "other liabilities and provisions" in schedule five of balance sheet.

(ii) Floating Provisions

Board of directors committee of banks will establish a floating provisions level for specific purposes to meet advances and investments. Floating provisions are maintained as per the guidelines of RBI and should get approval from RBI. Floating provisions include,

1. Provisions on leased assets

2. Provisions on advances under rehabilitation.

3. Provisions on advances against bank term deposits.

4. Provisions for take-out finance.

5. Provisions for maintaining reserves to meet fluctuations in exchange rates.

6. Provisions for country risk.

7. Provisions for financial asset conversion to SC/RC as per RBI circular.

Gross NPA

Gross NPA is given as the total loan assets of banks/ financial institutions classified as NPA's as per the RBI guidelines. Gross NPA's include the assets such as sub-standard, doubtful and loss assets. Gross NPA represents the quality of the loans granted by banks. Gross NPA ratio can be calculated using the following formula,

$$\text{Gross NPA ratio} = \frac{\text{Gross NPA}}{\text{Gross advances}}$$

Net NPA's

Net NPA's is given as the gross NPA after deducting the provisions from gross NPA's. They represent the actual burden on the banks.

Net NPA's = Gross NPA – Provisions

Banks should maintain provisions for the NPA's and are to be deducted from the gross NPA to arrive at net NPA's.

$$\text{Net NPA ratio} = \frac{\text{Net NPA}}{\text{Gross advances - Provisions}}$$

2.8.1 NPA's – Steps, Principles and Causes

Q25. Explain briefly about the various steps involved in the management of NPA's by banks.

Answer :

NPA Management by Banks

Performance of a bank can be assessed by determining the quality of loan assets as it constitutes an important element for the survival of the bank. But, non performing assets became detrimental to the quality of loan assets of bank. Banks have several measures for reducing the NPA's. They are,

1. Micro level budgeting
2. Review of NPA accounts
3. Recovering from NPA's by establishing separate department or by mergers.

Since many years there has been a substantial decrease in the recovery of NPA's. Now RBI has implemented some measures to enhance the recover of NPA's such as,

1. Debt recovery tribunals
2. Lok adalats
3. Corporate debt restructuring
4. SARFAESI Act.

RBI set guidelines for the NPA transactions in 2005 and modified them in May 2007. These guidelines facilitate the healthy secondary market for NPA's. These guidelines provide the banks the procedure for NPA transactions in secondary market such as selling and purchasing NPA's, pricing, provisioning, accounting, recovery disclosure etc.

As per the revised guidelines, banks should recover the loan amount within a span of three years by realizing at least 10% of the cash flows in first year and after that 5% for every six months.

In May 2005, parliament passed Credit Information Companies Act (CICA) and enacted this Act with rules and regulations in 14 by December 2006. The main objective enforcing this Act is to strengthen the NPA recovery mechanism statutorily. The features of CICA include,

(i) An efficient system to collect credit information regarding the borrowers of bank to enhance the better management of risk involved.

(ii) To facilitate an efficient secondary market for NPA transactions.

(iii) Analyse the processes and maintain transparency in lending practices.

(iv) Impart training to bank managers/employees regarding appraisal and established guidelines.

Various Acts such as SARFAESI and DRT are also found effective in strengthening the recovery of NPA's. Till now six restructuring companies started the recovery operations, however RBI issued certificate of registration to 11 RCs/SCs. By the end of June 2008, total ₹ 41,414 crores amount has been recovered by SC/RCs of which ₹ 8,319 crores are subscribed security receipts and ₹ 1,299 crores are redeemed receipts.

NPA Strategy

In order to determine the creditworthiness of borrower, banks have to analyse the performance of asset portfolio. Different banks follow different approaches. Example, DEI's use "interest cover approach" to determine the quality of asset portfolio by analyzing the borrower's ability to generate cash flows from the assets. This approach also determines the stress levels involved and the necessary steps to be followed to overcome it.

Some banks use aggressive approach which is most effective to deal with defaulters to facilitate or expedite debt recovery in early stages. For enviable and historical NPA's, an exist strategy and practical approach need to be followed which focus more on time value of recovery and settlements.

Transparency and Disclosures

Transparency constitutes one of the important features of an efficient and strong financial system. In order to reduce the crisis and to maintain strength and stability of the banks and financial system, it is necessary to maintain transparency and interacting proper monitoring and control with market discipline. It is not possible to identify the area in which the risks are highly concentrated without having sufficient credit information. For this, both financial transparency and disclosure constitute important factors. Banks can analyse the players activities, performance, financial health, and credit file with the help of accurate information. Disclosure facilitates strengthening the efficient incentive system of banks and reducing the systemic risks by enhancing market ability under stress.

After conducting extensive research on accounting and disclosure practices Basel committee prepared a report on the impact of transparency and disclosure of financial information in maintaining market discipline and supervision. This committee established transparency and disclosure standards along with other banking supervisors as the goal is more challenging and dynamic. Narasimhan and Verma committees recommended the banks for reducing the NPA's.

Tribunals

Debt recovery tribunals helped banks in reducing the accumulation of NPA's in banks and financial institutions. But the performance of DRT's is not marked in recovery from NPA's as it recovered only Rs.1,864 crores with the amount of Rs.42,988 crores still pending. Sick industrial companies Act and Board for Industrial and Financial Restructuring (BIFR) has implemented legal proceedings for loan recovery. Recently India is in view of creating and strengthening asset liability management systems.

RBI plays an important role in a shift of financial system towards pragmatic approach. India can have a holistic view on the issues and risks involved by analyzing the relations between RBI, banks and other financial institutions.

Q26. Discuss in detail about the various principles causes for NPA's.

OR

"The functioning of NPA's is effected by various factors". Explain.

Answer :

Transformation of performing assets into non-performing assets is influenced by the various factors/ reasons. The principles and causes for NPA's are divided into there heads, which are as follows,

1. Causes for NPA's by borrowers
2. Causes for NPA's by banks or internal factors
3. Causes for NPA's beyond the control of bank and borrowers or external factors.

Let us discuss each category in detail below,

1. Causes for NPA's by Borrowers

The reasons for the creation of NPA's in the banks due to borrowers include the following,

(i) Borrower's default to avoid the repayment of loan.

(ii) Poor quality of assets that cannot be liquidated for loan recovery.

(iii) Inefficient management of the firm to generate proper cash flows.

(iv) Death or disability of the borrower.

(v) Borrower's interest in taking advantage of the funds for illegal purposes.

(vi) Fluctuations in exchange rates during exports and imports of products.

(vii) Lack of proper monitoring and control on costs.

(viii) Lack of utilization of sophisticated systems such as technological advancements, research and developments, quality control etc., for effective results.

(ix) Internal disputes among the borrowers/partners of the firm.

(x) High fluctuations in demand.

2. Reasons for NPA's due to Banks or Internal Factors

Internal factors that are responsible for the creation of NPA's in a bank are,

(i) Poor appraisal system of bank to assess the quality of the project.

(ii) Poor assessment of returns associated, creditworthiness of borrower and his ability to face the risks.

(iii) Lack of proper follow-up mechanism to expedite the loan repayment procedure in banks.

(iv) The strategy of target orientation to accomplish the goal quickly only in terms of credit expansion which leads to poor quality of loans and results in NPA.

(v) Lack of proper networking and information sharing regarding the creditworthiness and credit file of borrowers among the banks.

(vi) Lack of flexibility in interest rates of loans.

(vii) Lack of proper administration or documentation of loans.

(viii) The legal proceedings on the default borrowers is time consuming process.

(ix) Government also not framing any policies to support the bank for recovering the loans from defaulters.

3. External Factors

External factors that contribute for the creation of NPA's include,

(i) Involvement of political leaders.

(ii) Slow growth of economy.

(iii) Time lag in the completion of project to meet the demand because of depressing capital markets.

(iv) Rapid changing policies of government to regulate trade.

(v) Lack of proper infrastructure facilities for trade.

(vi) Natural calamities such as earthquakes, floods etc. results in loss of markets.

(vii) Schemes and policies introduced by government to safeguard the poor borrowers become an advantage for default borrowers resulting NPA's.

(viii) Loopholes in the government policies and law facilitating the borrowers to avoid repayment of loan.

2.8.2 Implications and Recovery of NPA's

Q27. Discuss in detail about the implications of NPA's.

Answer :

Implications of NPA's

NPA's have a great effect on the activities of banks and financial institutions. The following discussion depicts the impact of NPA's. They include,

I. Impact of NPA's on Banks

Accumulation of NPA's in banks have a major effect on the activities of banks. They includes,

1. NPA's affect the profitability of the banks by transforming performance assets into doubtful or loss assets. Banks need to maintain provisions for uneffective assets which is an additional cost that does not yield any returns.
2. NPA's also affect the interest income of banks as it does not yield any interest to bank.
3. The productivity and ability of the asset to generate cash flows will also get affected by accumulation of NPA's.
4. NPA's adversely affect the capital adequacy ratio of the banks as it is highly associated with 100% risk and does not generate any cash flows.
5. Accumulation of NPA's leads to increase in cost of capital and in disparities between assets and liabilities.
6. NPA's will also affect the economic value addition of banks.
7. Management of NPA's incur costs of carrying blocked funds which may lead to increase in operational costs.
8. NPA's may adversely affect the moral of the operational staff and identity of the banks.
9. NPA's also become a hurdle for rating the performance of banks by credit rating agencies.

II. Impact of NPA's on Financial Institutions

The following are the effects on NPA's on activities of financial institutions.

1. NPA's have adverse effect on the capital adequacy and net worth of the financial institutions.
2. NPA's affect the systematic stability of financial institutions that results in number of problems in financial system and economy of the country as a whole.
3. NPA's become the establishing factor in some countries such as Japan,
4. A crisis in any country has resulted because of the currency and banking crisis that occurred because of the high accumulation of NPA's in financial institutions.
5. Like NPA's in banks, NPA's in financial institutions also affect the productivity and efficiency of institutions and it became detrimental to the health of financial institutions.

Though NPA's have adverse effect on the banks performance, every bank still possess a minimum amount of NPA's as it is not possible to eliminate the NPA's completely. Banks can identify the future occurrence of NPA's by monitoring the growth of existing NPA's which helps them to take proper measures to minimize them.

Q28. How does banks and financial institutions recover the default NPA's?

Answer :

Recovery of Default NPA's

RBI and government provided a broad framework for NPA management, its recovery and restructuring. Individual banks and financial institutions can also craft recovery policies, negotiation and compromise statements by themselves for debt recovery from defaulters.

RBI provided a procedure to banks for loan recovery in annual policy statement of 2004-05. Similarly individual banks have to establish a committee including chairman and managing directors of bank for identifying the defaulters and crafting a redressal mechanism/forum for addressing recovery issues and problems.

Lok Adalats

Banks and other financial institutions can also go for lok adalats for reducing NPA's in banks. Lok adalats are established by DRT's for addressing the recovery cases ranging above one million of NPA's.

DRT's

DRT's are the tribunals established for resolving the cases regarding NPA recovery. In 1993 parliament enforced "Bank and Financial Institution Act" under which they established the framework for immediate recovery from NPA's. By the end of 2003, DRT resolved 25,510 cases from the whole of 61,301 and recovered 68.74 billion amount. Recently RBI requested government to improve the DRT's for better functioning by appointing a working group/ committee.

Asset Reconstruction Company (ARC)

"Securitization and Reconstruction of Financial Institution Act" (SARFA) was enforced in 2002 for establishing asset management companies for resolving the issues or cases of NPA's accumulated in banks. The authorized AMC has a right to acquire the assets of any bank and financial institution by issuing a bond or security based on the previous agreed consideration and conditions.

ICICI bank along with other banks and financial institutions has established asset reconstruction companies.

The following are the steps that should be followed for effective recovery from NPA's of defaulters,

1. Banks and financial institutions need to establish goals for NPA recovery and for prevention also. For the accomplishment of goals they should establish a separate recovery department for managing the recovery operations.
2. Banks should remind the borrowers regarding their repayments and monitor the performance of the business.
3. As per the guidelines of the bank, issue a proposal for compromise.
4. Again send reminders to defaulters for advance.
5. Then file a case against them in any tribunal.
6. Under the SARFAESI Act issue a notice of 60 days to borrower for his response.
7. Under the transfer of property Act call for auctions regarding the recovery operations.
8. Conduct recovery competition and offer rewards for highest amount recovery.
9. Further banks can follow any other measures for strengthening its recovery operations and need to update the NPA status and quality after recovery.

Q29. Write about NPA, gross and net concept of NPA along with causes, implications and recovery of NPA's.

OR

Discuss the causes and implications of NPA in banks. Suggest measures for recovery of NPA's.

(Model Paper-II, Q7(b) | May/June-16, Q3(a))

(Refer Only Topics: Causes for NPA's, Implications of NPA's, Recovery of NPA's)

OR

Explain the causes for NPA (Non Performing Assets) and its implications. *April/May-15, Q3(b)*

(Refer Only Topics: Causes for NPA's, Implications of NPA's)

OR

What do you mean by NPA's? Explain the causes, implications and recovery of NPA's.

April/May-14, Q3(b)

(Refer Only Topics: NPA, Causes for NPA's, Implications of NPA's, Recovery of NPA's)

OR

Explain the gross and net concept of NPA's, causes, implications and recovery of NPA's.

(Refer Only Topics: Gross and Net Concept of NPA's, Causes for NPA's, Implications of NPA's, Recovery of NPA's)

Answer : *May/June-12, Q3(b)*

NPA

For answer refer Unit-II, Page No. 2.25, Q.No. 24, Topic: NPA–Features.

Gross and Net Concept of NPA's

For answer refer Unit-II, Page No. 2.27, Q.No. 24, Topics: Gross NPA, Net NPA's.

Causes for NPA's

For answer refer Unit-II, Page No. 2.28, Q.No. 26.

Implications of NPA's

For answer refer Unit-II, Page No. 2.29, Q.No. 27.

Recovery of NPA's

For answer refer Unit-II, Page No. 2.29, Q.No. 28.

2.9 PRIORITY SECTOR LENDING

Q30. Discuss in detail priority sector lending.

Answer :

Priority Sector Lending

Priority sector refers to that sector of the economy which accelerates the pace of over all development of India. The concept of "Priority sector lending" basically evolved in the year 1967. The National Credit Council (NCC) stated that "The priority sector should include the agricultural sector, small scale industries and exports of the economy".

The list of priority sectors was increased after the nationalisation of banks, in 1969. The new list of priority sectors included retail trade, professional and self-employed individuals, house loans, education loans for poorer classes and also consumption loans.

The nationalisation of the banks brought good results for the priority sector. The level of credit provided by pubic sector banks to priority sector increased greatly. The union government suggested the public sector banks that the level of credit provided to priority sector must not be less than one-third (1/3) of the bank's total outstanding credit by March, 1979. The concept of priority sector lending was defined by the 20 point economic programmes headed by Dr. K.S Krishnaswami and the working group. The main aim/goal was to provide financial help to those sectors which would help in the development of national product.

Categorisation of Priority Sector Lending

The priority sector lending has been categorised/classified according to the master circular July 1st, 2010 as follows,

1. Agriculture (Direct and Indirect Finance)
2. Micro and small enterprises (Direct and Indirect Finance)
3. Micro credit
4. Educational loans
5. Housing loans.

RBI Guidelines for Priority Sector Lending

In the year 1980, the RBI provided the following priority sector lending guidelines for the banks to follow,

1. A minimum of 40% of a bank's advances need to be provided to the priority sector, such as agriculture, small scale industry and so on.
2. Out of the total advances to the priority sector, a minimum of 40% advances should be provided to the agricultural sector.
3. Bank should cover 50% direct lending for agriculture. This 50 percentage should consist of direct advances given to agricultural weaker sections and allied activities of rural areas.
4. The advances given to cottage industries, artisans of rural areas and craftsmen of village should be at least 12.5% of the total advances given to the small-scale industries.
5. Banks are required to provide 12% of credit advances to the exporters.

Recommendations of Narsimham Committee and Indian Banks Association (IBA) Panel

The Narsimham committee recommended the following points with respect to the priority sector lending,

1. The committee firstly recommended that the priority sector needs to be redefined.
2. The aggregate bank credit for priority sector must be fixed at 10% instead of 40% which is the prevailing percentage.
3. Policies related to the priority sector must be checked after every three years.
4. The concept of sector lending should be entirely phased out slowly.

Recommendation of IBA (Panel)

The Indian Banks Association (IBA) has formed a panel which suggested the Banking Sector Reforms (1998) to the Narasimham committee. The recommendations of the IBA panel are as follows,

1. The aggregate bank credit to the priority sector should be reduced to 10% instead of the existing 40%.
2. The panel of bankers recommended that priority sector needs to be redefined. On the ground, that lending should be limited for only important sector and other types of loans must be handed over to the bank's commercial judgements.
3. According to the panel, rate of interest should be deregulated and banks must be given the authority to decide their own rate of interest on the basis of the prevailing market conditions such as cost of funds,cost of administration etc.
4. According to the panel, debt recovery target settled for different branches and which was located at district or state level must be linked with the recovery percentage.

However, the government of India rejected the recommendations of the Narsimham committee and continued with the existing priority sector lending policy.

Problems of Priority Sector Lending

The development of priority sector lending suffers from the following problems of banking sector,

1. The banks restored to indiscriminate lending in order to reach the target of 40%. In most of the cases, there was external pressure available on the bank to lend to the weaker sections.
2. The public sector banks face difficulties in monitoring the small size accounts of priority sector loans. It resulted in increased cost and low profitability.
3. The commercial banks were forced to keep maximum level of deposits in the form of CRR(15%) and SLR (38.5%), they held 53.5% to 55% liquid reserve till 1992. As a result, only 45% of deposit resources remained in the hands of these banks for providing loans and advances and out of this limited percentage of deposit resources, they were supposed to allocate 40% for priority sector. This resulted in low profitability.
4. Most of the banks lent to already developed states, ignoring the backward states like Uttar Pradesh, Bihar etc. This lead to further imbalanced regional development.

SHORT QUESTIONS AND ANSWERS

Q1. Causes for Increasing NPA's

Answer : *(Model Paper-I, Q2 | May/June-17, Q1(d))*

Transformation of performing assets into non-performing assets is influenced by the various factors/reasons,

1. Causes for NPA's by Borrowers

The reasons for the creation of NPA's in the banks due to borrowers includes,

(i) Borrower's default to avoid the repayment of loan.

(ii) Poor quality of assets that cannot be liquidated for loan recovery.

2. Reasons for NPA's due to Banks or Internal Factors

Internal factors that are responsible for the creation of NPA's in a bank are,

(i) Poor appraisal system of bank to assess the quality of the project.

(ii) Lack of flexibility in interest rates of loans.

3. External Factors

External factors that contribute for the creation of NPA's include,

(i) Involvement of political leaders.

(ii) Slow growth of economy.

Q2. SLR and CRR *April/May-14, Q1(e)*

OR

CRR

(Refer Only Topic: CRR)

Answer : *(Model Paper-II, Q1 | May/June-17, Q1(c))*

SLR

Statutory Liquidity Ratio (SLR) is a financial tool of RBI which is used for controlling the credit flow in the economy. This kind of ratio is maintained by every bank. It is considered as one of the most important ratios in banking sector.

CRR

Cash Reserve Ratio (CRR) is also a financial tool of RBI, which is used to ensure the liquidity and safety of banking sector deposits. It is a kind of ratio which needs to be maintained by every bank with RBI, as a certain percentage to meet their demands and time liabilities. The authority to change CRR is in the hands of RBI. If any bank fails to fulfill the requirements of the prescribed CRR, then RBI will impose penalty on such bank.

Q3. Sources of Bank Funds

Answer : *May/June-12, Q1(b)*

Bank is a type of business firm whose main objective is to generate profit. The banks can attain this goal by offering services to the customers. The banks provides different types of interest bearing obligations to the public which acts as sources of funds for the bank and are represented on the liability side of the balance sheet of a commercial bank. There are two key sources of bank funds, which are as follows,

1. Bank's Own Funds

There are three main types of bank's own funds i.e., paid up capital, reserve fund and portion of undistributed profit.

2. Borrowed Funds

The borrowed capital is one of the important and essential source of fund for every banking business. They are generated from the deposits which are accepted on different terms in different accounts.

Q4. Write about,

(i) Credit management

(ii) Credit appraisal.

Answer :

(i) Credit Management

The productive and profitable use of bank resources for achieving desirable economic growth is known as credit management. Credit management also ensures equal distribution among different segments for growth of economy without any barriers in the national objectives and the banking objectives. The planning, selection, analysis, budgeting, designing and implementation of schemes and plans completely relies on credit management. The credit management is linked to the management.

(ii) Credit Appraisal

The analysing of the financial, technical and managerial practices of firm's operations for estimating the need and end-use of short-term funds should be the basic goal of the revised system. The well-managed firm tends to be a better risk for the bank than the good will or amount of assets it holds.

Q5. Loan Pricing

Answer : *April/May-15, Q1(b)*

Earlier, banks were operated in an environment with regulations in terms of interest rates. Later the scenario has changed to deregulated environment with cut throat competition among the players in banking sector. To sustain in the price competition, banks are required to price their products/services by considering both profits and risk-return trade-offs. Banks should monitor and control their revenues and costs at the times of interest rate reductions.

For better pricing, banks should compare the loan pricing with product pricing. Like product pricing, loan pricing also considers the variable and fixed costs i.e., variable costs include costs of liabilities, whereas fixed costs include servicing costs and overheads for maintenance of accounts. Banks are also required to include profit margin in the price of the product or service. The loan pricing differs from product pricing in the following two ways,

(i) Loan pricing considers the quantification of risk while pricing.

(ii) Loan pricing relies upon the customer ability to generate profits to bank. It is also called "relationship pricing".

Q6. Different types of Loans

Answer : *(Model Paper-III, Q4 | May/June-16, Q1(d))*

Loans is a source of funds provided by banks to borrowers (firms/individuals) to satisfy their needs. Loans are classified into different types based on the purpose, collateral, maturity period, repayment structure and profile of borrower. They are,

(a) Working capital loans

(b) Term loans or industrial credit

(c) Loan syndication

(d) Agricultural loans

(e) Project finance

(f) Retail loans

(g) Non fund based credit.

Q7. Gross NPA's and Net NPA's

Answer :

Gross NPA's

Gross NPA is given as the total loan assets of banks/financial institutions classified as NPA's as per the RBI guidelines. Gross NPA's include the assets such as sub-standard, doubtful and loss assets. Gross NPA represents the quality of the loans granted by banks. Gross NPA ratio can be calculated using the following formula,

$$\text{Gross NPA ratio} = \frac{\text{Gross NPA}}{\text{Gross advances}}$$

Net NPA's

Net NPA's is given as the gross NPA after deducting the provisions from gross NPA's. They represent, the actual burden on the banks.

Net NPA's = Gross NPA – Provisions

Banks should maintain provisions for the NPA's and are to be deducted from the gross NPA to arrive at net NPA's.

$$\text{Net NPA ratio} = \frac{\text{Net NPA's}}{\text{Gross advances} - \text{Provisions}}$$

Q8. Customer Profitability Analysis

Answer :

The development of more detailed information system for tracking of costs by lenders has led to the introduction of Customer Profitability Analysis (CPA) technique for loan pricing. This technique is very much similar to the cost-plus pricing technique. According to this technique the revenues and expenses of a customer are taken into consideration for pricing of a loan. The CPA is calculated using the following formula,

$$\text{Net before tax rate of return to the lender} = \frac{\text{Revenue provide to the customer} - \text{Expenses of facilitating loans and other services to customer}}{\text{Excess of lonable funds used in customer's deposits}}$$

INTERNAL ASSESSMENT

I. Multiple Choice

1. The loan that is required to create a legally independent project company is called __________. [ ]
   (a) Retail lending
   (b) Project finance
   (c) Non-financial banking corporation
   (d) Loan syndication
2. Financing the supply side of the economy which is more customized is called __________. [ ]
   (a) Wholesale banking
   (b) Retail banking
   (c) Class banking
   (d) Either (a) or (c)
3. Which of the following does not constitute the reason for the problems in credit management? [ ]
   (a) Poor asset growth
   (b) Increase in risks
   (c) Lack of proper credit culture
   (d) None of the above
4. Which of the following is a tribunal that addresses the cases regarding recovery of NPA? [ ]
   (a) Lok Adalats
   (b) DRT's
   (c) Asset restructuring company
   (d) All the above
5. The pricing model which is based on the standard base rate is called __________. [ ]
   (a) Customer profitability analysis
   (b) Cost-benefit pricing model
   (c) Prime rate based model
   (d) None of the above
6. The components of loan price are __________. [ ]
   (a) Cost of funds
   (b) Servicing costs
   (c) Risk premium and desired profit
   (d) All the above

7. Which of the following is not a measure to reduce NPA's? [ ]
   (a) Micro level budgeting
   (b) Review of NPA accounts
   (c) Recover NPA's by mergers
   (d) None of the above

8. The pricing based on the target profits of the bank is called__________. [ ]
   (a) Customer profitability analysis
   (b) Cost benefit pricing model
   (c) Prime rate based models
   (d) None of the above

9. Long term loans are also called __________. [ ]
   (a) Working capital loans
   (b) Industrial credit
   (c) Retail loans
   (d) Project loans

10. __________ is a loan/asset that remains due for over a period of 180 days. [ ]
    (a) Non-performing assets
    (b) Performing asset
    (c) Either (a) or (b)
    (d) None of the above

II. Fill in the Blanks

1. __________ forms the primary and cheapest source of debt finance.
2. __________ is the most direct form of lending.
3. __________ provides ample and relevant information about the borrower's ability and credit worthiness.
4. The loans granted by a group of banks to a borrower is called __________.
5. __________ reflects the actions that a borrower should perform to carryon the business legally and ethically.
6. __________ and __________ are the most common forms of non-fund based credit.
7. __________ represents the quality of loans granted by banks.
8. The process of effective utilization of bank resources for accomplishing bank's objectives is called __________.
9. Loan pricing is also called __________.
10. __________ sector refers to that sector of the economy which accelerates the place of over all development of India.

KEY

I. Multiple Choice

1. (b)
2. (d)
3. (d)
4. (d)
5. (b)
6. (d)
7. (d)
8. (a)
9. (b)
10. (a)

II. Fill in the Blanks

1. Bank credit
2. Fund based lending
3. Credit file
4. Syndicated loans
5. Affirmative convenants
6. Letter of credit and letter of guarantee
7. Gross NPA's
8. Credit management
9. Relationship pricing
10. Priority.

III. Very Short Questions and Answers

Q1. What is Bank Credit?

Answer :

Bank credit refers to the credit which is being extended by the banks to borrowers or applicants. Irrespective of whether the borrower withdraws the credit amount or maintains it as a deposit with the bank, in both the cases involves the credit extended.

Q2. Define Short-Term Loans.

Answer :

Short-term loans are the loans which are provided by the banks usually with a maturity period of less than or equal to 1 year. The short-term loans are usually being granted with a basic objective of financing working capital needs of the borrower, arising out of the temporary build up of inventories and receivables.

Q3. Write a note on Credit Management.

Answer :

The productive and profitable use of bank resources for achieving desirable economic growth is known as credit management. Credit management also ensures equal distribution among different segments for growth of economy without any barriers in the national objectives and the banking objectives.

Q4. Explain about Cost-Benefit Pricing Model.

Answer :

In cost-benefit loan pricing model, banks often price their loans based on the standard base rate such as London Inter Bank Offered Rate (LIBOR) and prime rate.

Q5. Write about different Types of Lending.

Answer :

Lending is a practice of borrowing funds from a source of finance. Lending is basically of three types,

1. Fund based lending
2. Non-fund based lending
3. Asset based lending.

UNIT 3

Regulation and Innovations in Banking System

LEARNING OBJECTIVES

After studying this unit, one would be able to understand,

- Concept of 'Bank Capital' and why it is essential to regulate Bank Capital.
- Concept of Economic Capital and Regulatory Capital.
- Basel Accords I, II and III.
- Concept of Banking Innovations, Core Banking Solution and Different Innovative Products and Services in the Banking Sector.
- Concept of Retail Banking along with nature, scope and different Innovative Products and Services of Retail Banking.
- Concept of Electronic Clearing Service [ECS], its steps, ATM and Mobile Banking.
- Concept of Online Banking/Electronic Banking/Net Banking – Credits Cards, Debit Cards and Electronic Cash.
- Bancassurance and its Role in Banks and Insurance Companies.
- Different Models of Bancassurance.
- Payment and Settlement System in Banks – Clearing and Gateways.

INTRODUCTION

The term "bank capital" is referred to the net worth of a bank which is comprised of both assets and leabilities wherein, assets covers cash, securities, interest earned through loans, letter of credit, inter-bank loans, so on and liabilities covers loans, reserves and debt.

'Economic capital' means the amount of capital which banker must estimate with a view to cover the future losses which are associated with different types of risks.

Banks regulation has become essential due to crisis from the past two decades with a view to avoid losses theirby, concept of regulatory capital emerged. Both the concept of economic capital and regulatory capital acts as financial health of the banks.

Basel Committee on Banking Supervision [BCBS] introduced basel accords I and II to control the rules and regulations of banking system.

An increase in technological advancement has given rise to core-banking solution. Some innovative products and services offered by banks are personal banking, loan schemes, cards so on.

Retail banking is large-scale banking wherein, branches of large commercial are available for customers use and it is entirely different from wholesale banking. Retail banking offers different types of innovative products such as plastic money, ATM and mobile banking, online banking, e-cash, credit and debit cards.

NEFT (National Electronic Fund Transfer) is a substitute of EFT system which is electronic based payment system involved in implementing 'public key structure technology'.

3.1 REGULATION OF BANK CAPITAL: THE NEED TO REGULATE BANK CAPITAL

Q1. What do you mean by the term bank capital? Why it is needed to regulate bank capital?

Answer :

Bank Capital

Bank capital reflects the net worth of a bank. It consists of both assets and liabilities. Assets of a bank include cash, securities, interest generated from loans, letter of credit, interbank loans. Liabilities include loan loss reserves and debt.

Need to Regulate Bank Capital

Banks are included under the most regulated global industries. The regulation in banking sector is mostly in terms of capital regulation. The reasons for the regulation of bank capital is to mitigate the risk due to systematic crisis and the inability of the primary creditors or dependents to monitor the performance of the banks. Banks get insolvent due to their inability in repayment of the debts the creditors within the stipulated time. According to Modigti and Miller the capital structure of a firm does not effect it's value if the market is perfect and furnished with complete information. There has been observed a significant effect of deviations of markets from the perfect on the capital structure of the firm. The factors include taxes, financial distress, transaction costs, agency costs and asymmetric information are considered as the imperfections in case of all firms whereas especially in bank the two factors included in addition to these factors are,

(i) Access of bank to safety net or deposit insurance

(ii) The deposits from the small and uninformed depositors acts as sources of bank debts.

Traditionally the capital of a financial and non financial firm with less financial leverage and high long term debts is meant to mitigate risks through compensating the unexpected losses.

Balance Sheet of Manufacturing Firm

Assets	Percentage	Liabilities	Percentage
Cash	5	Owner's equity	40
Debtors	25	Long term debt	30
Inventory	30	Short term debt	10
Fixed assets	40	Creditors	20
Total	100	Total	100

Balance Sheet of Banking Firm

Assets	Percentage	Liabilities	Percentage
Cash	75	Equity and reserves	10
Loans and advances:			
Short term	40	Deposits	80
Long term	10	Borrowings	10
Investments:		Total	100
Short term	30		
Long term	10		
Fixed and other assets	3		
Total	100		

Comparison of the balance sheet manufacturing firm and a banking firm depicts following facts,

(i) The asset composition of a manufacturing firm is 60% current assets and 40% fixed assets whereas for a banking firm the composition is 77% current assets and 3% fixed assets.

(ii) The current ratio of manufacturing firm is 2 whereas for bank it is less than 1.

(iii) Liabilities of manufacturing firm consists of 60% debt and 40% equity for bank it is 90% debt and 10% equity.

(iv) If there is a decrease in the asset value, a manufacturing firm and can sustain the decrease upto 40% whereas a bank can tolerate only 10% fall in asset value.

Thus, high capital of a firm leads to an increase in the problem assets prior to the complete depletion of the capital.

When compared to manufacturing firms banks are associated with high financial risk because of the low composition of fixed assets and low operational leverage. But the market value of the assets of banks are more volatile than the assets of manufacturing firms. The change in the market value is due to the change in interest rates, default borrowers. Though fixed assets are said to be more liquid and are associated with less risks when compared to real assets, their liquidity is less in fact by the effect of number of factors.

The rate, tenor and composition of assets and liabilities vary from one firm to other. Mostly the risks associated with banks assets include credit risk, market risk due to wide fluctuations in interest rates and operational risks due to lack of proper infrastructure of banks. These risks in single or in combination may leads to substantial decrease in the value of the bank's assets.

In order to meet the obligations to the creditors banking firms requires periodical liquidation of assets. If there is a substantial decrease in the value of the assets banks should use the capital funds to meet the obligation, otherwise the bank is said to be insolvent i.e., if the bank has high capital sources there will be less risk associated with the banks as there will be an increase in the volume of default assets before their technical insolvency. The capital helps a bank in following ways,

(i) The capital funds compensate the losses incurred by banks

(ii) It ensure bank safety and encourage them to invest in the firms.

(iii) It ensures the investors and

(iv) It helps a fir to expand the scope of the business by reducing the nature of risk avoidance in order to improve the firms's profitability.

Regulation of bank capital is necessary even though it acts as a hurdle for its growth to a certain extent but is meant for mitigating the risk that exceeds the capacity of the bank.

How a Bank Capital Ensures the Bank Safety

The extent of capital that is required by the bank should be adequate to meet all the obligations effectively. Suppose the manufacturing and banking firms have a return on assets as 1 [i.e., ROA = 1], then ROE for each firm is calculated by using the following formula.

ROE = ROA × EM [For manufacturing firms

ROA = Return on assets ROE = 1 × 2.5 = 2.5

ROE = Return on equity For banks ROE = 1 × 10 = 10]

EM = Equity multiplier.

The EM of manufacturing and banking firms is 2.5 and 10 respectively. In the above example the ROE of banks is more than that of manufacturing time (4 times). This difference in the ROE of 2 firms is due to difference in financial leverage of both firms.

The positive returns of a firm will leads to high financial leverage which results in high profitability of the firm. Though the capital of a bank will ensure safety and stability it leads to a decline in the firm's profits. Therefore most of the banks are willing to maintain less capital funds.

It the returns of a bank are negative then the banks will incurr losses. Hence it is clear that the firms which are associated with low risks will have high financial leverage.

Comparatively banking firms are associated with default risk which is unavoidable by banks. To minimize the effect of these risks banks should maintain adequate capital in accordance with the risks of the assets.

3.1.1 Concept of Economic Model/Economic Capital

Q2. Explain the concept of economic capital of banks and write about various risks associated with it.

Answer :

Economic Capital

The amount of capital that a banker should estimate in order to cover the future losses that are associated with various risks is termed as "economic capital".

Banks should determine the amount of capital required to meet all the obligations and also to sustain in the banking sector associated with various risks, as the risks are unavoidable. The degree of risk associated with bank varies with the type of services offered by the banks. The various risks associated with banks are categorised into following groups.

(a) Credit risk

(b) Market risk

(c) Operating risk

(d) Liquidity risk

(e) Other risks.

Risk is generally the unfavorable deviation of the actual results form the expected results. A risk manager can model the probability of occurance of unfavourable results by using various mathematical and statistical techniques.

The economic capital estimates differ from the estimations of accounting capital accounting capital include book value of the stocks whereas economic capital represents the capital required to face the risks associated with banks. Most of the banks are now allocating the adequate economic capital internally by using advanted (mathematical) modelling techniques. For modelling the future risks and business banks are using the stochastically generated economic scenario.

In statistical terms economic capital is the difference between the loss distributed and the expected loss. The economic capital is also meant to cover unexpected losses at a selected confidence level (commonly the confidence level is 99.9%).

Various Type of Risks

The following are some of the types of risks,

(a) Credit Risk

Credit risk arises due to the default of the counter party or if the lending contracts are not fulfilled credit risk include the following,

(i) Counter Party Default Risk

It arises due to the default of the other party of agreement.

(ii) Equity Risk

It arises due to the unfavourable fluctuations in price equity which results in the depreciation of the investors funds in stock market. Mostly company specific factors contribute for the occurance of equity risk.

(iii) Securitization Risk

The process of transfer allocation of risk by pooling the debts and issue of securities backed by the pool is called securitization. It is of 2 types traditional and synthetic. In traditional securitization originated bank is involved in transfer of risk instead of the assets.

(iv) Concentrated Risk

This risk arises due to the high losses that ray affect the credit worthiness of the bank to perform the basic activities.

(b) Market Risk

It is defined as the risk associated with the fluctuations in the prices in both money and capital markets and in foreign exchanges. Markets risk include the following,

(i) Interest Rate risk

It refers to the fluctuations in the capital structure of the bank due to the interest rate fluctuations. IRR management system is involved in measurement and control of the risks in both trading and banking book. IRR consists of the following types,

1. **Repricing Risk**

   Arises due to change in interest rates which have a significant effect on assets and liabilities.

2. **Yield Curve Risk**

   Arises due to unanticipated shift in slope and shifts of yield curve which may result in changes in bank's portfolio.

3. **Basis Risk**

   Arises due to lack of proper correlation between the index rate in different markets.

4. **Optinality Risk**

   Arises due to changes in the interest rate options.

(ii) Equity Price Risk

It refers to the fluctuations in the market price of equity. These fluctuations are influenced by general market related factors.

(iii) Foreign Exchange Risk

It refer to the fluctuations in the exchange rates of equity.

(c) Operating Risk

The loss that is incurred due to the lack of proper infrastructure is referred to as operating risk. It consists of legal risk rather than strategic and reputational risks.

(i) **Legal Risk**

The loss incurred due to lack of proper institution/ implementation of the effective policies, procedures that are enforced by law is referred to as legal risk.

(ii) **Documentation Risk**

The uncertainties resulted from the lack of proper documentation system is called documentation risk. This may leads to ambiguities in understanding the features of the financial contract by the parties involved.

(d) **Liquidity Risk**

It refers to the inability of a bank to meet all the obligations. It includes the following risks,

(i) **Term Liquidity Risk**

It refers to the unanticipated extension of the term period in lending transactions.

(ii) **Withdrawl or Call Risk**

It refers to the excess of deposits that are withdrawn than the expected. This may leads to poor credit worthiness of bank to meet the obligations.

(iii) **Structural Liquidity Risk**

It refers to the failure of bank to offer required funds. It is also called funding liquidity risk.

(iv) **Contingent Liquidity Risk**

It arises due to the additional funds or replacement of the natured liabilities in adverse situations.

(v) **Market Liquidity Risk**

It arises if the banks fails to market the position within the stipulated period or market them at a discount. These risk is common in case of securities/derivatives of liquid market and marketing large positions. The risks can be accounted by extending the holding period or by using expected values based the bankers experience.

(e) **Other Risk**

The other risks associated with banks include,

(i) **Strategic Risk**

It arises due to the adverse effect of the business strategy and policies on the profitability of the firm.

(ii) **Reputational Risk**

It arises due to the unfavorable deviation of bank's reputation from the expected levels.

(iii) **Capital Risk**

It arises due to luck of proper balance between the capital structure and the nature and size of the bank.

(iv) **Earnings Risk**

It refers to the inability of the bank to enhance the adequate profitability of the banks due to the lack of proper diversifications of bank's profits.

Bankers should maintain high levels of economic capital at a higher confidence level in order to gain more profits. Economic capital will compensate only the unexpected losses but not the catastrophic losses.

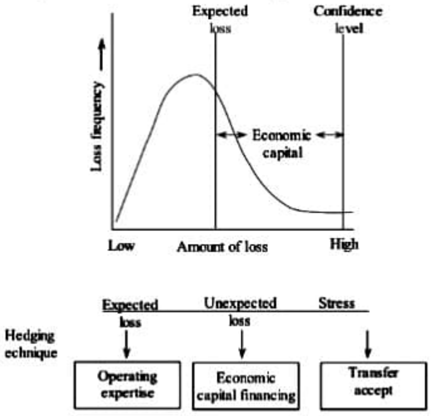


Figure: Economic Capital and Hedging Techniques for Losses

3.1.2 Concept of Regulatory Capital

Q3. Explain the concept of regulatory capital of banks.

Answer :

Regulator Capital

There has been an increase in the regulations on the bank capital due to the crises in past 2 decades in order to avoid the occurance of loses. These regulations are due to lack of correlation between the demand for deposit withdraws and the return on assets of the banks. This mismatch has resulted in an adverse depositor's behaviour i.e., withdrawl of the deposits to a large extent than actual by the investors which may leads to insolvency of banks. Regulation of banks assures the depositors regarding the future payment of their deposits and the credit worthiness/ liquidity position of the bank following are the various ways in which a bank will assure the depositors,

(i) Adequate bank equity

(ii) Deposit insurance

(iii) Lender of last resort

(iv) Subordinate debt.

The inability of banks to provide above assurance to depositors will leads to bankruptcy and dose not results in optimal outcomes. Banks should be very careful in framing the assurance as they play a key economic role in achieving optimal outcomes.

Both regulatory and economic capital are related to the financial health of the banks. A regulator can estimate the regulatory capital based on the preestablished confidence level but the response of regulatory capital to common variables affecting both capital levels differ from the response of economic capital. The common variables include loans probability of default (PD) and loss given default. This depicts the lack of proper coordination between the regulatory and economic capital. The economic capital is essential for bank shareholders whereas the regulatory capital is important for depositors of the bank.

Risk Base Capital Standards

Since 1980 there has been an increase in the concern about the financial health of the international banks as a result of an increase in complaints against unfair competetion in global banking sector. The Bank for international settlements and Basel committes (BCBS) are established to determine capital standard for banking firms.

Bank for International Settlements (BIS)

BIS was established in 1930, it is the first international financial organization. The head office of BIS is located at Basel Switzerland. The main objective of BIS is to expedite the financial and monetary relationships among the firms internationally, The BIS acts as,

(i) Bank for central banks

(ii) Forum for conducting discussion among central bank for taking effective decisions.

(iii) A center for conducting economic and monetary researches,

(iv) A prime counter party for central banks

(v) An agent/trustee the financial operations across the world.

BIS include 55 central banks along with RBI and provide them the rights to vote and represent in the general meeting conducted by it.

BIS is not allowed to accept deposits or to offer financial service to individuals or corporations and to maintain any account with government in order to maintain the position of bank for the central banks. Thus it only provide financial services to central banks and monetary authorities including,

(a) Management of foreign exchange reserves.

(b) Standard and innovative investment and asset management services

(c) Collateral short term credits

(d) Agency/trustee services to international government loans.

In addition to the above services offered to central banks BIS also engaged in the following activities,

(i) Conducting regular meetings which includes the governers of central banks and other senior officers in order to monitor the performance of banks in fostering the financial and economic growth across the world and also to resolve the issues to maintain stable monetary and financial position of banks.

(ii) It is engaged in hosting the secretariats BCBS, committees on payment and settle systems, Global financial system and market systems.

(iii) BIS is involved in supporting the meetings of the various committees.

(iv) It also conduct researches in economic, monetary, financial and legal areas.

(v) It also helps in statistical information sharing among the central banks for publishing in various markets.

(vi) It is also engaged in establishing financial stability institute to enhance the implementations of robust financial standards in all the central banks.

Basel Committee on Banking Supervision

For answer refer Unit-III, Page No. 3.6, Q.No. 4, Topic: Basel Committee on Banking Supervision.

3.1.3 Basel Accords – I, II and III

Q4. Write in detail about the Basel Committee on banking supervision. Explain Basel Accord I.

Answer :

Basel Committee on Banking Supervision

Basel Committee on Banking Supervision (BCBS) was established in 1974 by the governers of central banks which are the members of GIO countries. The members of the committee has been categorised into four main groups and conduct meetings regularly, i.e., four times a year. The central banks of the GIO countries represent the member countries of the committee and the governers of the central banks will be reported by the basel committee. The primary objective of basel committee is to monitor the international banks performance and supervise them to achieve standards established by BIS and to issue a long series of documents. The head office of BIS at Basel will appoint of the secretariat of Basel committee.

Basel committee has introduced the bank capital management system called Basel capital accord in 1988. Basel committee is not provided with formal authority to supervise and to issue conclusions. It can establish superior standards and guidelines and recommendations regarding the best practices for the central banks. The international bank capital regulation has been introduced since 1988 with the introduction of Basel accord capital standards by BCBS. The accord is signed by the members of GIO countries and is applicable to the international central banks. At the time of inception the accord emphasise more on the measurement and definition of capital standards to minimize the credit risk but later the members has amended the accord and is now applied to most of the central banks across the world.

The first basel agreement emphasie more on the relationship between the capital and asset structure of the banks.

(i) Capital requirements of a bank to cover the losses due to credit risk can be determined by considering the asset composition of the bank. The bank require high capital funds if their assets are associated with high default risk.

(ii) Identification of important role of owner's equity in capital structure by considering the risk of the assets and the minimum capital requirements.

(iii) Established the standard capital norms to all countries.

BCBS has amended the accord in order to cope up with the innovations in financial service considering all the risk associated with it.

Basel Accord I

Basel Accord I was established in 1988 which states that central banks of members of GIO countries should maintain a minimum capital that i.e., equal to least 8% of the assets associated with different risks. The capital composition according to Basel Accord I consists of 2 components,

(i) Shareholder's equity and retained earnings

(ii) Additional internal and external sources of bank.

Banks should maintain atleast half of the capital with a composition of shareholder's equity and retained earnings. Bank manages can measure the risk using portfolio approach in which the assets are categorised into four groups 10%, 20%, 50% and 100% based on their quality. This categorization represents the proportion of assets that are risk free and the proportion that is associated with risks. The primary objectives of this accord are,

(i) To ensure the minimum required capital levels in an international banking system.

(ii) To level the playing field in terms of competetion to avoid the capital inadequacy problems.

In 1990 this accord is applied by 100 countries for their banks by considering it as world standard accord. However, this accord has certain drawbacks such as,

(a) There exists a conflict in the regulatory measures with an increase in the advanced internal measures of economic capital.

(b) The simple bucket approach that is followed in this accord leads to decrease in the volume and quality of the assets.

(c) It fails to identify the credit risk minimization techniques.

(d) The capital requirements of the accord lack proper economic basis and the risks assigned to the assets failed to reflect the risks associated with borrowers.

(e) It fails to account the benefits gained due to asset diversification.

Thus, with an increase in research BCBS has introduced various alternatives to the accord to establish capital standards for internationally active banks.

Q5. Explain briefly Basel Accord II. Discuss in detail about the three pillars on which the development of Basel-II has been built.

Answer :

Basel II

Basel Committee on Banking Supervision (BCBS) has set up basel capital accords. Basel accords are formal agreements between two organizations to control the rules and regulations of banking system. Basel I was published in 1988; whereas, Basel II was issued in June 2004. Officially, Basel II was known as "The international convergence of capital measurement and capital standards". The basic purpose of Basel II is to allocate the capital in an optimized manner to protect against various types of risks.

Three Pillars of Basel II

In earlier days, the performance of banks was not adequate and hence lead to failures of many banks. This further instilled the fear that the whole economic system would collapse.

Therefore, to safeguard against the failure of banks, basel has formed the third pillar which has implemented a minimum Capital Adequacy Ratio (CAR) for banks to distribute the funds in a specified ratio which is justifiable in global economy. But Basel I was inadequate due to immense changes in banking industry. So, Basel II, a new capital adequacy framework has been formed. Basel II is much simpler and effective than Basel I.

Therefore, to enhance the strength and reliability in financial system, Basel II has developed three pillars, namely,

1. Pillar I - Minimum capital requirements
2. Pillar II - Supervisory review process
3. Pillar III - Market discipline.

Fist Pillar - Minimum Capital Requirements

Banks face credit risk, market risk and operational risk. So, pillar- I aims to calculate capital by considering all these risks.

Regulatory Capital

Capital of Basel I is almost similar to Basel II, but is slightly changed to improve. Capital has been divided into two tiers.

In tier I, 50% of capital is allocated for equity and known reserves.

In tier II, remaining 50% for general provisions and unknown reserves.

Capital ratio needs to be at least 8% to control market, credit and operational risk.

1. **Credit Risk**

In a contract, when any one party fails to fulfill his financial obligations, then it is termed as credit risk.

This risk is a general and widespread risk and hence needs to be managed carefully by following two approaches which are hereunder,

(i) The standardized approach or external ratings based approach.

(ii) Internal Rating Based (IRB) approach.

They are of two types,

(a) Foundation IRB and

(b) Advanced IRB.

(i) The Standardized Approach

The national supervisor under the principles of Basel II has permitted the External Credit Rating Agency (ECRA) to allot ratings to the parties. And risk weights are calculated by these ratings.

The standardized approach to control risk has set up certain risk weights which are fixed in nature to every asset group. Due to the changes, the system of risk weights differ from Basel I to Basel II. Basel I consists of five risk weights (i.e., 0, 10, 20, 50 and 100%), whereas Basel II risk weights vary from 20% to 150%. If it is a low rated secured asset then the risk weights increase to 350%. Presently, the Basel II possesses13 categories and usually the status of rating is AAA, AA, A, etc.

(ii) The Internal Ratings Based (IRB) Approach

So far the banks have taken the help of supervisory review process and disclosure requirements. In addition to this, banks can also depend on their estimations of risk for calculating capital. Under this approach, banks have classified six asset classes by thoroughly analyzing all the possible risk elements. They are equity, sovereign, purchased receivables, bank, corporate and retail.

IRB has further possessed two approaches. They are,

(a) Foundation IRB approach and

(b) Advanced IRB approach.

(a) Foundation IRB Approach

Under foundation IRB approach, for all types of risks banks depend on estimates made by supervisory control, except excluding the probability of default risk. Only for this risk, banks depend on their own estimations.

(b) Advanced IRB Approach

Under advanced IRB approach, banks calculate and evaluate risks, like PD (Probability of Default), LGD (Loss Given Default) and EAD (Exposure At Default) by their own method, but they are liable to answer about their work to national supervisor.

2. **Market Risk**

Banks face market risk when market prices fluctuate due to interest rates. This risk effects the off-balance sheet as well as the on-balance sheet items and further becomes difficult for the banks to survive.

Market risk needs to maintain certain capital to control risk for instance,

(i) Foreign exchange risk.

(ii) Risk of interest rates and equities.

There are two options to control risk, one is through maintaining a trading book. In a trading book, all the details of buying and selling like price, time etc., would be specified and parties trade with their securities. All the details of securities have been continuously altered and accurate values are placed. Whereas, the second option is the application of a hedging strategy to safeguard from risk.

For interest rate risk BCBS has published two strategies based on the bank's trading and nontrading activities.

When banks involve in trading activities, BCBS has issued "Market Risk Amendment". Whereas, when banks involve in nontrading activities, BCBS has estimated "Principles for the management and supervision of interest rate risk" under principles 14 and 15.

3. **Operational Risk**

When a firm fails to manage internal and external affairs then it is termed as operational risk.

BCBS has classified several reasons for operational risk. They are as follows,

(a) Internal Frauds

When management discriminates among employees; when employees do not follow the rules and regulations.

(b) External Frauds

Termed as external mistakes are the losses arising due to forgery, hacking of computers, robbery, etc.

(c) Employment Practices and Workplace Safety

When the management is biased towards employees with regard to their rules, compensation and shows discrimination.

(d) Business Disruption and System Failure

Losses occurred due to the failure of computers hardware and software, telecommunications, and when the supply of utilities (like electricity and water) is not proper.

(e) Clients Products and Business Practices

When a firm sells products which are not licensed and fails to fulfill their duty towards reliable clients.

(f) Execution, Delivery and Process Management

When losses arise due to the failure to deliver in time, legal documents being inadequate, not able to possess good relations with suppliers and vendors, errors in data entry.

Capital Requirements for Operational Risk

Operational risk has been emphasized in three categories, i.e., cause, event and effect. Cause and events are already concentrated by traditional operational risk management. It studies the quality, whereas this operational risk concentrates on effect by emphasizing on quality risk in money form.

To measure capital requirements for operational risk, Basel II suggests three approaches which are hereunder,

(i) Basic Indicator Approach (BIA)

(ii) The Standardized Approach (TSA)

(iii) Advanced Measurement Approach (AMA).

(i) Basic Indicator Approach (BIA)

In BIA, gross income (GI) of the fixed percentage is equal to the capital charge.

It is given as,

$$K_{BIA} = \frac{[\Sigma(GI_{1....n} X_{\alpha})]}{n}$$

Where,

K_{BIA} – Capital charge

GI – Positive annual gross income for three years

n – Number of previous three years

According to national accounting standards or national supervisor,

Gross Income = Net interest income + Net non-interest income

This has been designed to fulfill the following,

(a) It depicts net operating expenses which include payment to persons who out sourced the work.

(b) Any requirement to be in gross form.

(c) Do not consider insurance income and irregular items.

(ii) The Standardized Approach (TSA)

TSA determines capital charge, when every business line of Banks' gross income is multiplied with fixed percentage (beta factor). Eight business lines have been categorized for banks by Basel II and those are commercial banking, payment and settlement, trading and sales, retail brokerage, agency services, retail banking, and asset management.

It is given as,

$$K_{TSA} = \frac{\{\Sigma_{year1-3} \max[\Sigma(GI_{1-8} \times B_{1-8}),0]\}}{3}$$

Alternative Standardized Approach (ASA)

BCBS has adopted ASA to prevent double counting of credit risk. Double counting means each transaction is calculated more than once. Procedure for calculating operational risk in ASA differs from TSA for retail banking and commercial. Being the procedures same for the rest of the business lines,

It is given as,

$$K_{RB} = \beta_{RB} \times m \times LA_{RB}$$

$$K_{CB} = \beta_{CB} \times m \times LA_{CB}$$

Where,

RB – Retail banking

CB – Commercial banking

m = 0.035

LA – Average of loans and advances for previous three years.

Apart from the above formula, committee has recommended banks to apply TSA in the following ways,

(a) For retail and commercial banking - Beta of 15%

(b) For other six business lines - Beta of 18%

Supervisor identifies beta factor under TSA,

ASA capital = Σ(Eight business lines capital)

When gross income is negative then capital would be negative. Therefore, a positive charge of one business line would balance the negative charge of another business line and on the whole, if the capital is negative, then it is considered as zero.

(iii) Advanced Management Approach (AMA)

Under the AMA, banking institutions have the facility to calculate their capital for operational risk. But for this, banks must prove that their strategy is strong enough to compare with the other approach.

Steps

1. Banks need to categorize their business unit into each of their business lines.
2. Based on their internal data, banks need to calculate PE (probability of a loss event) and LGE (loss given that event) to all its business lines.

   Then the Expected Loss (EL) is given as,

$$EL = EI \times PD \times LGE$$

The following is the capital calculated for operational risk.

$$ORC = \Sigma(EI \times PD \times LGE)$$

When the banks have given permission to apply advanced measurement approach, then they are not supposed to apply other approaches except when the supervisor suggests to do.

Second Pillar – Supervisory Review Process

Importance

This process acts as a powerful technique to control risk. Apart from possessing minimum capital, it also enables to maintain sufficient capital, so as to control internal affairs, maintain certain reserves and provisions.

To improve Pillar II needs to focus on certain sectors which are hereunder,

1. Bank's external factors such as effects caused due to business cycle.
2. Though credit risk is a part of Pillar I, it wasn't controlled completely.
3. Need to concentrate more on minimum standards and advanced approaches such as AMA and IRB.

For supervisory review, BCBS has recommended four principles as follows,

Principle 1

Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

The following is the process,

- Participation of the senior management and board
- Evaluation of capital
- A clear calculation of risk
- Monitored and reported
- Reviews the internal control.

Principle 2

Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

At the time of reviewing, supervisors need to focus on off-site and on-site inspection, checking the work of external auditors, discussing with bank management and reporting periodically. Apart from this, it also needs to calculate the adequacy of capital and risk, focus on minimum standards, control environment and reaction of supervisors.

Principle 3

Supervisors should accept banks only who operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4

Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action, if capital is not maintained or restored.

Therefore, on the whole, the second pillar aims at enhancing the capital and controlling risk for the long run.

Third Pillar – Market Discipline

Pillar 3 supports in fulfilling the objectives of pillar 1 (minimum capital requirements) and pillar 2 (supervisory review process). BCBS plans to promote market discipline by disclosing key facts by banks to public, which enables market participants to know about the essential information concerned with the capital, risk exposures, and scope of application. With this, market has an idea of bank's appropriate capital and its associated risks. Pillar 3 has ordered banks to provide the details in every six months. However, the international banks need to report, for every quarter, about the details of capital adequacy ratios and about a sudden change which creates a risk to any firm. Banks objectives and policies need to be revealed once in a year.

Disclosure Requirements

(a) General Disclosure Principle

Banks need to frame certain official disclosure rules and regulations. If the disclosure rules are effective, then board of directors permit the banks to follow the rules.

(b) Scope of Application

Pillar 3 focuses on strengthening the banking division only to the top level.

(c) Risk Exposure and Evaluation

Market participants look at the way banks identify, monitor and control risk. Pillar 3 displays all the possible measures to control various types of risks, like safeguarding the assets and reducing the credit risk. Banks need to design certain goals and principles to attain perfect risk management. They are,

(i) Strategies and processes

(ii) Hierarchy of risk management

(iii) Steps to control risks and observe that these steps have been implemented effectively

(iv) Scope and nature of risk reporting.

Q6. Discuss Basel Accord III and explain the major highlights of the draft guidelines.

Answer :

Basel Accord III

The draft of guidelines was issued by RBI to explain the proposed implementation of Basel-III Capital Regulation in India. The above mentioned regulations are made to address the Basel III which is a global regulatory framework for more resilient banks and banking systems of the BCBS [Basel Committee on Banking Supervision] which was introduced in 2010 December.

Major Highlights of the Draft Guidelines

The following are some of the major highlights of draft guidelines,

1. Minimum Capital Requirements

The essential minimum capital requirement is,

(a) The capital of Tier I should be atleast 7% of Risk-Weighted Assets (RWAs).

(b) The capital of Common Equity Tier I (CET 1) need to be atleast 5.5% of Risk-Weighted Assets (RWAs).

(c) Total capital should be atleast 9% of Risk-Weighted Assets (RWAs).

2. Capital Maintenance Buffer

The capital should be maintained in the form of common equity as 2.5% of Risk-Weighted Assets (RWAs).

3. Transitional Arrangements

The transitional planning relating to draft guidelines are,

(a) It is proposed to implement the requirement of capital conservation buffer between 31st March 2014 and 31st March 2017.

(b) The period of minimum capital requirements and deductions from common equity is planned to be implemented from 1st January 2013 and complete on 31st March 2017.

(c) During the period from 1st January 2013 to 31st March 2022, the instruments which are not qualified as regulatory capital instruments will not be used any more.

(d) By considering the feedback given on these regulations the proposed implementation schedule is finalized.

4. Increasing Risk Coverage

Banks are supposed to determine an additional Credit Value Adjustments (CVA) risk capital charge apart from the counter partly capital charge for default risk under current exposure method in case of OTC derivatives.

5. Leverage Ratio

From 1st January 2013 to 1st January 2017 is a parallel run for the leverage ratio during this period banks are expected to function at a minimum Tier I leverage ratio of 5%. By considering the Basel Committee's final proposal the leverage ratio requirement will be decided.

3.2 BANKING INNOVATIONS - CORE BANKING SOLUTION

Q7. What do you mean by banking innovations? Explain the new concept of innovations in banks.

Answer : *(Model Paper-I, Q8(a) | April/May-15, Q4(b))*

Banking Innovations

Banking innovation generally refers to bringing new concepts and technologies in the sector of banking in order to enhance technological advancement and to improve the performance of the banking system. This innovation helps the customers in accessing all the facilitates related to bank in an efficient manner.

Definition

According to Teece, "Innovation is a process where knowledgeable and creative people and organizations frame problems and select integrated augment information to create understanding and answers".

Innovative Products and Services

Corporation bank has been updating their banking operations according to the technological advancements in the market across the 1000 branches since many years. The latest IT services offered by corporation bank include phone banking, any branch banking, ATM services, internet banking etc. Thus, it is successful in reducing the NPA's and in increasing the returns.

Innovations in Banks

Some of the innovative products and services offered by banks include,

1. Personal banking
2. Loan schemes
3. Cards
4. High-tech banking products and services
5. Products and services for non-residents
6. Other important services.

1. Personal Banking

The banking services under this category include various deposit schemes to satisfy the diversified needs of customers. The deposit schemes cover recurring, one term, short term, long term, high interest, high liquid or both.

(a) Savings Account

Corporation banking offer the following services under this group.

(i) Any Branch Banking

Under this facility an account holder can access in any of the branch of the bank located in any country place.

(ii) Corp Power Cheque

It is also called multi city cheque facility in which the account holder can realise the cheques in branches across 170 cities.

(iii) Free International Debit Card/ATM

Under this facility banks will allow the depositor to withdraw cash from the VISA ATM across the world and also online ATM's.

(iv) It also facilitates internet banking.

(v) Corp Senior Account

This is a form of saving account that enable monthly payments to parents or elder dependents of customer.

(vi) Corp Elite Account

This account is an innovative product and is a premium saving account which has a facility to obtain free add on.

(vii) Corp Classical Account

This account enables the customers to gain interest on the deposits at predetermined rates.

(viii) Corp Jeevan Raksha

This account offer like insurance coverage to depositors of the bank with the corporation of LIC.

(ix) Corp Anytime Premium

This account facilitates the customer to pay premium for life insurance contracts from their bank account.

(b) Current Account

The customers of current account include businesses, firms, companies, public enterprises etc., which are engaged in daily banking transactions. This also facilitates the account holder to deposit and withdraw the money at anytime, anywhere and any number of times unlike savings account, current account does not offer the interest earnings and savings but facilitate banking transactions for business purpose. The major types of current account include corp business, corp business premium, corp business club and corp business privilege.

(c) Term Deposit

The various term deposit plans offered by banks include,

(i) Kshemanidhi Cash Certificates

It is a money multiplier deposit or reinvestment term deposit scheme in which the depositor can earn a compound interest at the end of each quarter. The deposit period ranges from 6 months- 10 years. The period of deposit selected by the depositor determines the rate of interest offered by the bank.

(ii) Money Flex

It is a flexible fixed deposit scheme in which a customer is facilitated to withdraw the money at his interest at any time within the period of deposit. The period of deposit ranges form 6 months to 120 months and the minimum deposit amount is ₹ 5,000/- and a depositor can add the deposit amount in multiples of 1,000/-.

(iii) Fixed Deposits

It is one of the term deposit plan in which depositor can earn interest periodically. The period of deposit ranges from 15 days to 10 years.

(iv) Corp Classic

This term deposit scheme is a technology based account that offers an advantage of high liquity and high returns to a depositor which yields best returns on their deposits. The depositor can withdraw or compound the interest earnings on the deposit money.

(v) Continuous Deposit

It is also called cluster deposit scheme in which depositor should maintain the deposits in a cluster form by the selection of either simple or compound interest option. Bank will record total deposits in a pass book for easy retrieval.

(vi) Ready Cash Deposit

Under this scheme a bank will offer the advantage of high returns and liquidity along with cheque facility to depositor for their convenience to withdraw the money when every required. The minimum deposit amount is ₹.5,000 and the period of deposit is 12-36 months.

(vii) Recurring Deposits

Under this scheme a depositor can deposit a fixed amount every month at an interest rate fixed by the bank. The deposit term ranges from 12-120 months during which the interest rate is compounded at the end of each quarter. This scheme is also available for minors.

(viii) Premium Deposit

Under this scheme customer should maintain a minimum of ₹.100 month. The deposit period is 1 to 10 years. At the end of the term he/she can reinvest the interest plus deposit amount in order to earn high interests.

(ix) Janatha Deposit

Under this scheme bank will appoint a collection agent to collect the deposits from the customers periodically sometimes everyday. The period of deposit is 1 to 5 years. At the end of the term the customer can gain high amounts from the periodical small savings.

2. Loan Schemes

Banks provide a wide range of loans to its customers to meet their diversified needs. The loans include, Housing loans, Education loans, Consumer loans, Automobile loans (Two wheeler and four wheeler), Loans against future rent receivables such as lease/hire purchases, Loans against shares, Medical loans, Loans for purchasing office premises, Gold loans, Personal loans, Property and mortgage loans.

Corporation bank with cooperation of LIC of India provides life insurance coverage to customers in addition to house loans.

3. Cards

Cards include both debit and credit cards,

(i) Debit Cards

Offer the following advantages to customers,

- Customers can use these cards for purchases across the world.
- Customers will be provided with the accounting statement after every transfer/withdrawal which helps in proper management of the funds.

(ii) Credit Cards

Credit cards offer several advantages to customers including,

- They are accepted by most of the merchandises.
- They are used to book tickets, withdraw money at specified ATM's.
- It provide free credit for a period of 45 day.
- It also offer free personal accident insurance to couple, baggage insurance cover and purchase protection cover.

4. High Tech Banking Products and Services

For answer refer Unit-III, Page No. 3.15, Q. No. 9, Topic: High-Tech Banking Products and Services.

5. Products and Services for Non-Residents

For answer refer Unit-III, Page No. 3.16, Q. No. 10.

6. Important Services

The various quality services that are offered by banks to different classes of customers include,

	Service		Description
(i)	Any branch banking	❖	Refer topic: Any branch banking in deposit schemes of same question. The services that are available under this are: cash withdrawal, cash deposit and local cheque deposits, transfer of funds, and DD purchases.
(ii)	Corp Power cheq	❖	Refer topic: corp power cheq in same question.
(iii)	Corp mediclaim	❖	Bank offer medical insurance coverage benefits for their customer with the cooperation of partners of general and life insurance companies under this scheme. This scheme provides cashless claim settlements, protection coverage to dependents and premium savings.
(iv)	Corp E-rail	❖	This service is used to book railway tickets through internet. Banks offer this service in association with Indian Railway Catering and Tourism Corporation Ltd. (IRCTC).
(v)	Corp bill pay	❖	Customer can also pay bills through internet from their bank accounts. Rather than using cheque payments they can pay any payments with just a mouse click.
(vi)	Corp mobile recharge	❖	Customers with ATM/debit cards are also provided with an electronic prepaid recharge for their mobiles form their accounts.
(vii)	Corp anytime premium	❖	Refer topic: corp any time premium in the same question.
(viii)	Corp Junior	❖	Under this service the parents can remit the funds for free to their children (students) across the country with the presense of nationwide online ATM network.
(ix)	Mutual funds	❖	Banks also acts as financial supermarket to offer its customers the facility to purchase various financial products such as mutual fund products either equity, diversified or sectoral funds.
(x)	Depository services	❖	All the investors should maintain a deposit account or demat account to continue their access with the Indian capital markets as their transactions are transformed to dematerialised form.

Q8. Explain in detail about the concept of core banking solution.

Answer :

Core Banking Solution

Core banking solution is defined as the set of robust software components or integration of core banking components that are developed and tailored to satisfy the requirements of the individual businesses in order to face the challengers in the banking sector. The modules of core banking solution include saving bank account, current account, fixed deposits, cash credit, etc., and in addition include ATM and internet banking. While replacing the traditional solutions with core banking solution, banks should follow a holistic approach to minimize and effectively manage the risks associated with it.

There has been an increase in the technological advancement which resulted in the generation of core banking solution. The reasons for this are,

(i) Increase in cut throat competition

(ii) Market expansion and

(iii) Reduction in the costs of the products.

In order to sustain in the cut throat competition, the banks have to align the information technology strategy with the objectives of the banks by periodic review of the technical environment. Thus, the implementation of core banking solution in a banking system become an unavoidable process.

In the recent days banks should be very flexible to change in accordance with the rapid change in business dynamics. The technology acts as a key enabler and a driver of change. RBI also promoting the technological advancements and implementations of core banking solution in the banking infrastructure.

Banking products are highly functional and flexible to robust technological changes and also developed using web models with high levels of customer support services (24 × 7) in order to gain and retain competitive advantage in banking sector.

Core banking solution promote the business transaction by introducing advanced technologies. CBS include core banking, consumer and corporate e-banking, mobile banking and web based cash management systems.

Features of Core Banking System

The following are the characteristic features of core banking,

(i) The customers are allowed to perform their work relating to banking from any place around the world.

(ii) Banking facility is available for 24 × 7.

(iii) Business Process Re-engineering (BPR).

(iv) Incorporated with planned sectors.

(v) Supporting MIS, DSS and EIS.

Benefits to the Banking Firms

The benefits that are offered by core banking solution to the banking firms include,

(i) It provides a strong and reliable operational customer database and customer administration to organization.

(ii) It helps in enhancing the customer services and in reducing the costs. It also enhance the rapid growth in the flexible product portfolio of banks to meet the rapid changing market environment.

(iii) Core banking solution play a key role in increasing productivity of banking firms by reducing the errors.

(iv) It provides support for multi-currency operations.

(v) It expedites the baking operations by introducing 24 × 7 online transactions and customer support services.

(vi) It is engaged in the generation of accounting and management information based on the operational data in order to analyse the profitability and management of risk.

(vii) It facilitate the rationalization of process infrastructure in order to reduce the costs and to enhance the operational efficiency of the system.

(viii) It also reduces the maintenance and apgradation costs by extending the functional areas of core banking solution.

The implementation of core banking solution in a banking system which lack proper planning hurdles the smooth flow of customer services which results in delays in the customer requests and also in transactions. These problems are very common in the starting stages of implementation. The implementation of a core banking solution in a bank can be expressed in the following equation.

$$T + OO = COO + CC$$

Where,

T = New technology ; OO = old organization

COO = Costly old organization

CC = Confusion and chaos.

The time limitations in the implementation results in low access of server and lack of proper training to staff to handle the new technology. The banks can achieve the benefits of core banking solution after successfully facing the problems in the initial stages and also by establishing objective for controlling and by changing the audit processes of the bank.

Q9. Write a detailed note on banking innovations we have witnessed in the last decade. Also explain IT products of banks.

Answer : *(Model Paper-II, Q8(a) | May/June-17, Q4(b))*

Banking Innovations that are Witnessed in the Last Decade

For answer refer Unit-III, Page No. 3.11, Q.No. 7, Topic: Innovative Products and Services.

High-Tech Banking Products and Services

The various high-tech banking products and services include,

(a) Internet banking

(b) E-cheques

(c) Tele-banking.

(a) Internet Banking

Online banking may be defined as a "Procedure that allows individuals to perform banking activities from home or the roads using an internet connection". Online banking is also known as e-banking, cyber banking, virtual banking or home banking. Some of the traditional banks also offer online banking facilities such as ICICI bank, State Bank of India etc. Also there are some other banks which do not have any physical identity, but they provide online services. Online banking enables customers to perform all routine transactions, such as account transfers, balance inquiries and bill payments. Some of the banks even offer online loan and credit card applications. It also allows the user to access an account information at any time (i.e., 24 hours a day, 7 days in a week and 365 days in a year).

Online banking uses today's computerized technology in order to bypass the time consuming process of traditional banking and to manage public finances more quickly and efficiently. The customer has to just register himself/herself for one of the online programs introduced by a bank i.e., they have to provide ID and fill a form at any of the bank's branch. In case if a person or his/her spouse wishes to view and manage their joint account online, in such a case they have to sign a durable power of attorney then only the bank will display their holdings together.

(b) E-Cheques

Electronic cheques is another form of electronic payment system. These cheques are preferred when a customer is willing to make a payment without using paper cash. The e-cash system is generally an electronic implementation of paper cheques system. These cheques make use of digital signature for signing and endorsing and uses digital certificates to authenticate the buyer, buyer's financial institution and the buyer's account. Digital signature authentication is provided by using public key cryptography.

On-line services provided by electronic cheques allows,

1. The seller to verify if the buyer has sufficient funds in his/her account.
2. Improved security at each step of transaction processing.

The following are the steps for performing e-cheques transaction.

1. Before using an e-cheques, the purchaser must register himself with the billing server which also acts as account server.
2. Depending on billing server, the registration process may differ in a way that some account server require a credit/debit card to prove one's identity or needs to have a bank account.
3. After registration process is completed, a buyer can purchase any product or service by contacting a seller.
4. After purchasing has been done, purchaser sends his details along with e-cheques information to seller which presents it to the accounting server for verification.
5. Once the cheques is deposited in the bank, the payer's identity is authenticated and balance in the account is checked.

Electronic cheques is a form of electronic document which contains the following information.

(i) Payer's name

(ii) Bank's name

(iii) Account number of payer

(iv) Payee's name

(v) Amount to be paid.

Using electronic cheques, security and authentication is provided using digital signature. If the process of authorization is completed successfully, the cheques can be exchanged electronic between banks using electronically clearing network as a medium.

(c) Tele-Banking

Banks offer tele-banking services to it's customers to facilitate convenient banking operations. These services are 24 × 7 and will furnish the customers with the relevant information they require. They can get details about he account balance and the recent transactions through these services. Tele-banking is simple and safe in assisting the customers for speed and secure transactions through the implementation of interactive voice responsive system.

Tele-banking services are offered even for other individuals to furnish general information about the products and services offered by the bank and the rates of interest.

Q10. Discuss briefly about the various innovative banking products and services proposed for non-residents of India.

Answer :

A bank can use satellite based communication system for effective communication and computerised operations in order to achieve high levels of customer satisfactions. They have highly networked branches in NRI belts such as Kerala, Goa, South Karnataka, Gujarat, Mumbai and New Delhi. Corporation bank is maintaining foreign current accounts in 15 currencies in association with international banks.

The following are some of the schemes proposed for non-residents of India,

1. **Schemes without Repatriation**

Non resident ordinary scheme does not offer the repatriation of the current earnings on the deposit amount. These accounts are maintained by crediting the current earnings such as dividends, interest etc., The interest rate offered by banks is 3.5%. Banks are not subjected to any restrictions in determining interest rates.

2. **Scheme with Repatriation**

The schemes with repatriation are,

(i) Non resident external deposit schemes offer repatriation facility to NRI's under this scheme banks will pay the interest for domestic deposits at par value. The rate of interest is fixed using fixed/floating pricing models. The interest rate should be in the limit of ceiling rate given by RBI.

(ii) Under foreign currency non resident deposits scheme the principal/interest is repatriated. The Indian banks that are dealing with these deposits are engaged in exchange of 5 foreign currencies (USD, GBP, EUR, AUD, CAD).

(iii) Under resident foreign current deposit scheme a depositor/NRI who can return to their country can open these account under any one of the following schemes,

(a) Current accounts

(b) Savings bank accounts

(c) Fixed deposits

(d) Cash certificates

(e) Money flex

(f) Recurring deposits.

These current, savings and recurring deposit are not included under foreign currency non-resident deposits scheme.

3. **Pay Quick.com**

Pay quick.com is an organisation which enable the banks and other financial institutions by offering full fledged information for remitting funds through online at the interest of NRI's corporation bank mostly use the services of this company to attract NRI customers.

This is the technology based product offered by banks for the convenience of NRI's which ensure the speed, safe and cost effective transfer of funds.

Banks are now using the advanced technologies for an efficient communication process to enhance the speed, time and cost effective and convenient transfer of funds in India for NRI customers.

The two options that are offered to NRI customers include,

- Transfer in form of DD's in Indian rupees from any bank or exchange house abroad which are associated with Indian banks.
- Transfer in from of DD's in foreign currency. In this option banks will remit the amount in the form of DD in denomination of foreign currency for the payment in foreign countries.

4. **Telegraphic Transfer**

It is also called wire transfer which ensure quick transfer of funds. The specific characteristic of the wire transfer are banks will provide a SWIFT connection to all the branches. Each branch will receive the advices from the benefited bank after crediting the amount in the account of that bank in form of a 3 digit code along with swift code of the bank E.g.: CORPIN BBxxx.

This transfer will permit the branch to transfer the funds immediately. The telegraphic transfer is time effective transfer, which require only one day or few hour to transfer between the branches of same bank otherwise it require 3 days for transfer.

5. **Portfolio Services**

NRI's can invest their funds in shares/securities as per the guidelines mentioned by portfolio investment scheme introduced by corporation bank.

3.3 RETAIL BANKING - PRODUCTS AND SERVICES - CONCEPT, NATURE, SCOPE AND FUNCTIONS

Q11. Explain the concept of retail banking. Discuss its functions and obligations of banks.

Answer :

Retail Banking

The financial dictionary defines the retail banking as "a retail bank is a bank that caters for ordinary individuals and small businesses, as distinct from large corporations. Retail banking operations offer deposit facilities, lend money, transfer funds and are prepared to deal in relatively small amounts".

Retail banking refers to large scale banking in which branches of large commercial banks are available for use of customers. Savings and current accounts, mortgages, personal loans, debit cards, credit cards and many other services are offered by the retail banks.

Retail banking is different from wholesale banking and used by individuals that who are opposed to wholesale banking. The concept of retail banking is not new but has gained popularity asset recently. It attracts those segments of the market which offer growth and profit opportunities. The individual customers are the core of retail banking. The retail banking handles the wants of individual customers in an integrated manner. The retail banks too target high net worth individuals and their service include deposit and asset linked products.

Functions of Banking

The various functions of the banks are being represented in the following figure.

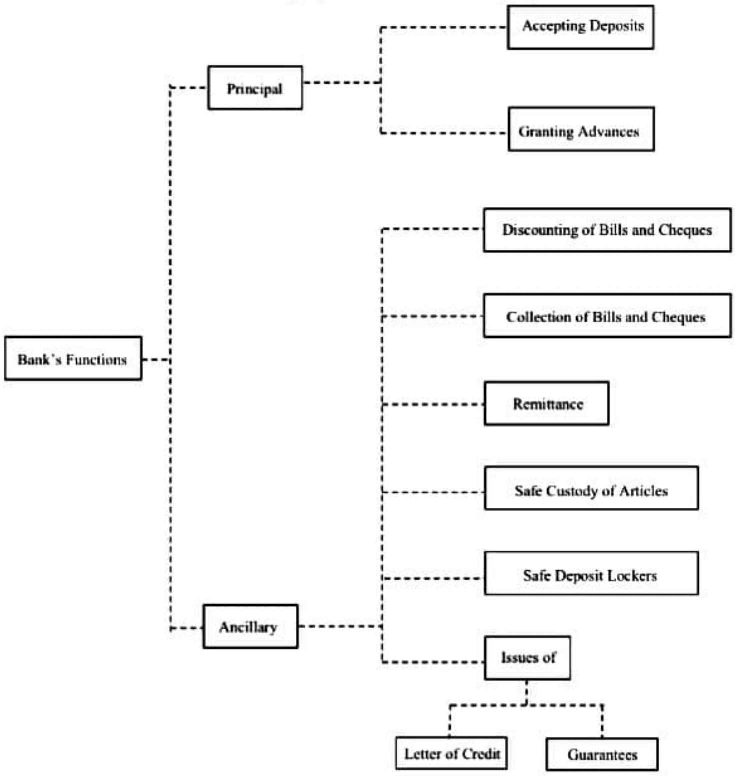


Figure: Functions of Banking

The functions of banks are mainly divided into two main heads viz., principal and Ancillary which are further divided into two sub-heads i.e., accepting deposits and granting advances.

1. **Accepting Deposits**

   Banks accepts the deposits in two ways,

   (i) Time deposits

   (ii) Demand deposits.

(i) **Time Deposits**

Time deposits are as fixed deposits which are repayable after the expiry of specified time period i.e., ranging form 7 days to 120 months.

(ii) **Demand Deposits**

This is further classified into two,

(a) Saving deposits and

(b) Time deposits.

2. Granting Advances (and loans)

Banks usually offers different types of loans such as personal loans, education loan, home loan (or) property loan, vehicle loan, gold loan to purchase consumer durables, business loan and so on.

These loans are offered for a period i.e., which is to be repayable within months (or) a year as per the amount of the loan.

Ancillary functions of banks is classified under different groups such as,

(a) Discounting of Bills and Cheques

Banks discounts bills-of-exchange and cheques. "Bill-of-exchanges is an instrument in writing that contains an unconditional order signed by the maker, directs a person to pay contain amount of money to a certain person (or) to the order of that certain person (or) to the bearer of instrument". Cheque is also similar form of bills-of-exchange wherein, three parties are involved i.e., Drawer, Drawee and Payee.

(b) Collection of bills and Cheques

Banks also carriers out the function of collecting bills and cheques.

(c) Remittance

Banks also render remittance services by transferring the funds (or) money from one place to another with the help of talex, cables, telegrams so on.

(d) Safe Custody of Articles and Safe Deposit Lockers

Banks performs an important function of especially for its customers known as 'custodial service' where in it offers safe custody of articles and deposits in the form of lockers.

(e) Issue of Letter Credit and Guarantees

This new service aids corporate customers in funding their imports. A financing company of home country make arrangements with the foreign financing company and enables the importers to import on deferred payment terms. The LOC is a way of temporary financing on certain terms and conditions for imports. It also forms a source of foreign exchange.

Obligation of Banks to its Customer

Different obligations of banks to its customer are as follows,

1. To pay cheques as per the section 31, of the Negotiable Instalment Act.

   Certain exceptions if banks are justified in returning cheques,

   (i) When cheque is being,

   (a) Post-date

   (b) Crossed and presented for cash payment

   (c) Bearing alterntion and

   (d) Presented

   - After banking hours.
   - After receipt of stop payment letter 1 attachment order/gamishee order.
   - After receipt of information about, Dealt, Insolvency (or) unsound mind.

   (ii) Incase of inadequate/inadequacy of funds.

2. To maintain secrecy, exception to be provided if banks are justified in giving information regarding,

   (a) Under law

   (b) With respect to customer.

3. Not to close the account.

4. Collection of bills and cheques.

Q12. Write about the nature and scope of retail banking products. Write a short note on remittance products.

Answer : *(Model Paper-III, Q8(a) | May/June-16, Q4(b))*

Nature and Scope of Retail Banking

The term "Retail banking" consists of various activities such as retail deposit schemes, retail loans, credit cards, deposit cards, insurance products, mutual funds, depository services like the demat facilities.

Retail banking deals with different products and services which forms the great part of assets and liabilities segment of the banks.

In simple works, the term banking refers to the process of fulfilling different needs of individuals related to deposits, advances and associated services.

Retail Banking Remittance Products

The retail banking and remittance products includes as follows,

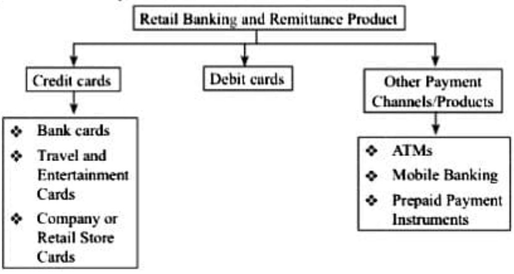


Figure: Retail Banking and Remittance Products

For remaining answer refer Unit-III, Page No. 3.23, Q.No. 17, Topic: Types of Plastic Money.

Q13. Write in detail about the various problems associated with retail banking.

Answer :

The retail banks face various problems. Some of the issues of retail banking are as follows,

1. **Knowing the Customer**

Every branch of the bank is to maintain the records of its customers. These records include consumer preferences, spending patterns etc. For this purpose the banks are to maintain data warehouses.

2. **Technology Issues**

Retail banks require large amount of investments in technology. Technology is the crucial requirement for establishing customer relationship management system or loan process automation or other convenience facilities to the customers. The selection of appropriate technology at the right time is one of the crucial problem.

The citibank which had introduced the new technology made profits only after a decade. Therefore, appropriate and sufficient technology support ensures better handling of transactions and reduces its costs.

However, the problems of lack of connectivity, lack of convergence, stand alone models etc. have been overcome.

3. **Organizational Alignment**

The organizational culture and practices play a vital role. The banks must set-up a competitive business strategy before stepping into retail banking. The organizational structure must facilitate the business operations and must endure easy work flow. The organizations must establish the organizational capacity required to achieve the desired results.

The organizational alignment requires the setting-up of an effective corporate marketing division. The marketing department ensures brands expansion, high net worth customer groups, improves the value of institution and its product. Most of the public sector banks only have publicity departments and their is absence of the much needed marketing departments. These marketing departments also facilitate smooth tie-ups with manufactures/distributors/ builders.

4. **Product Innovation**

The product innovation is still one of the major problem of retail banking. Among new products launched on a regular basis very few turn out to be successful. Today bank must introduce products that meet the needs and requirements of consumers. The existing products should be improved by adding new features to attract new consumers.

5. **Pricing of Product**

Setting-up the right price for the product is also one of the challenges for retail banks. Every bank aims at providing a better product at a relatively low price. However, these product are nor priced in a transparent manner and involve many hidden charges. This issue needs to resolved rather sooner than later.

6. Process Changes

Business process reengineering is an essential requirement for the growth of retail banks. Introducing automatic for carrying out similar tasks would not result in any improvement in organizations performance. The management of documents and work flow remain an important part of process change. Then documentation issues remain same in terms of submission at the time of loan application and upon execution.

7. Issues Concerning Human Resources

The human resources related issues are also in some of the major problems related to retail banking. The banks management should practice what is preaches. This should introduce initiatives that ensure improvement in delivery time and methods of approaches.

This would result in division of power among staff at various levels, devising appropriate tools for performance measurement. Introduction of universal tellers, bringing in transparency, coaching etiquette, good manners, etc., are the major factors that eliminate most of the issues related to human resources.

8. Rural Orientation

Retail banking is more popular in metros and cities. Most of the rural markets are yet to entered into the multinational corporations have been successful using the products, packages and promotions that focus on rural customers. The introduction of ₹ 2 jam sachets indicate the MNCs determination to capture the rural market.

Therefore, the public sector banks that bear a strong rural presence, must introduce strategies to capture the rural market.

Q14. Discuss briefly retail banking products and services.

Answer :

Now-a-days, banks are mainly concentrating on their small customers and providing a huge variety of retail services to them in place of large corporate organizations. Current accounts, investment advice and broking, mortages and loans, savings accounts are included in the retail banking services. The two important functions performed by retail banks for their customers are,

(a) It helps the customers to deposit their money safely easily operate it and perform their transactions.

(b) These banks provide facility to customers to utilize additional money to meet the expenses of their huge purchases like purchasing a house etc. The customers will also get interest for their investments in banks.

Products in Retail Banking

The products of retail banking are considered as influencing factors of banking industry around the world. The products which are provided by the different retail banks are as follows,

1. Property loans
2. Auto loans/used cars/new car loans
3. Home equity loans
4. Personal loans
5. Checking accounts
6. Recurring deposits
7. De mat accounts
8. Open end/closed end lease
9. Educational loans
10. Retail deposit products
11. Loan products
12. Professional loans etc.

Services in Retail Banking

There are two types of services which are offered by a retail bank,

1. Intermediation services, and
2. Payments services.

1. Intermediation Services

Some of the intermediation services that are offered by retail banks are,

(a) Loan or Credit Services

A large variety of loan products are provided by the retail banks to its customers. Some of the significant loan products that are provided by banks are as follows,

(i) Retail loans
(ii) Credit cards
(iii) Post-sale fiance or trade finance
(iv) Working capital facilities
(v) Business card
(vi) Personal overdrafts
(vii) Business/corporate credit.

(b) Deposit Services

Deposits are accepted by banks from its customers and provide them whenever they require. In general, the deposits are demand, fixed or time deposit. Demand deposits are those which are paid to customer on demand whereas fixed or time deposits are paid to customer after a fixed period of time. The main products that are provided by banks under deposit services are as follows,

(i) Fixed deposit accounts
(ii) Recurring deposit accounts
(iii) Current accounts
(iv) Savings bank accounts.

2. Payment Services

During these days, the concept of payment services is emerging in banking sector. Incase of payment services, after making payment of last installment the ownership is transferred. The installment purchase or hire purchase system comes under the important payment services.

Features

The important features of payment services are as follows,

(i) Customers need not make payment of full amount at the time of purchasing goods.

(ii) As income and expenditure are not synchronized, so a temporary store of purchasing power is made.

(iii) In order to make the payment of goods which are purchased a medium of payment is made.

3.3.1 Future and Strategies of Retail Banking

Q15. Discuss in detail the future of retail banking.

Answer :

Retail banking is highly important, relevant and equally essential matter to identify the causes which are behind the progress of retail banking in India. From past few years the retail lending is considered to be an outstanding innovation in commercial banking around the world. Particularly in developing economies like India, the development of retail banking is because of the improvements in information technology, reforms of financial market, several micro level demand and supply side factors and growing macro-economic environment.

Reasons for the Growth of Retail Banking

The following are the major reasons for the growth of retail banking,

1. Consumers are encouraged for retail banking due to prosperity in economy and increase in purchasing power. The growth of India's economy is at an average rate of 7-8% and continuously maintain same growth rate.
2. During last two years, there is decline in the treasury income of the banks which were previously strengthening the banks. In this situation, retail business acts as a better source of profit maximization.
3. Fear relating to corporate defaults and NPA determination.
4. As a result of competition, prices of automobiles and consumer goods are reduced.
5. The variations in consumer demographics increases the possibility of growth in consumption both qualitatively and quantitatively. The country which is having highest proportion (70%) of population below 35 years of age is India.
6. Taking into account that share of retail in impaired assets is very less compared to the overall bank loans and advances, retail loans impose comparatively less burden on banks except from expanding their income levels.
7. During 2000-2003, credit offtake from corporate sector and commercial sector was less.
8. Decrease in rates of interest also resulted in the development of retail credit by creating the demand for that credit.
9. Operations of stock exchange were automated and dematerialized.
10. Comparative safety imposed by the mortgage loans.
11. At the banking level retail banking was attracted because of its constant profits which can be utilized to overcome the volatility in non-retail businesses.
12. Convenience factors in retail banking are ATMs, direct debit and phone banking.
13. Utilization of credit cards and debit cards as plastic money was increased.
14. Large number of customers can help in marketing, mass selling and capability to divide customers by applying data mining/scoring systems.
15. The customers of retail banking are usually honest and do not shift from one bank to another frequently.
16. Development of other non-bank financial intermediaries.
17. Compared to big organizations, the retail business is having less inconsistency in demand and credit style.
18. Real estate, insurance and investments are advisory services provided by retail banking.
19. As the amount of loans are comparatively small, the credit risk is well diversified in nature.
20. Within the strategic framework risk management culture is integrated with available risk management instruments.

Q16. Write about the various strategies that need to be adopted for the success of retail banking.

Answer :

The following are the various strategies which ensure the success of retail banking,

1. Regular Innovation of Product to Meet Requirement Customer Agents

The banks can use the customer database available for targeting specific customers or introducing a new or modified product. The new products may be launched in the areas of securities, mutual funds and insurance.

2. Quality Service and Quickness in Delivery

The retail banks should focus on providing better quality service and ensure timely delivery in order to retail their customer. This is essential, as most of the banks today offer products with similar nature. The banks should also ensure that their services meet the customer requirements.

3. New Delivery Channels

The retail banks should introduce new delivery channels, such as branches, internet, ATMs etc., along with high quality service for their customers. Since, most retail customer, prefer banking through various channels.

4. **Tapping of Unexploited Potential and Increasing the Volume of Business**

The retail banking sector of India has much larger scope for growth for both banks and financial institutions. The demand for personal loans by modern Indian consumers can be met easily by the banks. The banks can expand their retail banking sector by importing special training to their marketing departments.

5. **Outsourcing of Infrastructure**

The outsourcing of business infrastructure reduces the cost of service channels, quality and quickness.

6. **In-depth Market Research**

The banks can gather details related to the products being offered by competitors in the market by conducting indepth marketing research. This enables the banks to offer better products and services compared to their competitors.

7. **Cross-Selling of Products**

The public sector banks can sell third-party products through their branches. These branches provide a wider network to PSBs.

8. **Business Process Outsourcing**

The business process outsourcing enables the banks to focus on major business area and also reduces its costs and saves time. Banks have more time for marketing their products, providing customer service and build a brand image in the market. For example. The ATMs management can be outsourced which eliminates the banks concern related to intricacies of technology.

9. **Tie-up Arrangements**

Forming strategic alliances with other banks enables the PSBs to reach new customers and new regions. Retail banking proves to be the only way out for banks in the present falling interest and tough competition situations. Therefore, banks must form alliances with other banks in order to improve retails banking sector. The banks should be able to predict consumer demand and expectations according to changing tastes and environments. The increasing competition forces the banks to move at a faster speed and ensure the survival of the fittest and fastest.

3.3.2 Plastic Money - Definition and Types

Q17. What do you mean by the term plastic money? Discuss briefly the various types of plastic money.

Answer :

Plastic Money

Plastic money refers to the replacement of currency notes into plastic cards. These plastic cards used in place of currency is known as the plastic money.

Plastic money's main objective is to ensure user's safety eliminating the risk of carrying cash. The postponement of actual payment or pre-purchase payment on the card issued are some of the other several objectives of plastic money.

Types of Plastic Money

There are various types of plastic money. Some of the common types of plastic money are as follows,

1. **Credit Cards**

In 1910, the first credit card was issued by sears. Later in 1949 the Diner's club was introduced. This card was operatable in multiple restaurants, that were the part of the scheme. The cards involved a small amount of or loan amount and had to be cleared in full within a month.

However, today credit cards offer short term loans and credit to its card holders. The bills are drawn upon customers on a monthly basis for the purchases made by them using credit cards. The card holders have the options of clearing the complete amount or the minimum payment amount decided earlier i.e., 2 percent or 3 percent of outstanding amount. The cord holder is granted a grace period and no interest is charged on loan during this period.

Credit cards are distributed using various means. Visa or master card are the most common general purpose cards. These cards are accepted by almost every merchant or retailer on a universal basis.

The credit cards are divided into three following types,

(a) **Bank Cards**

The cards offered/sponsored by individual banks and are used for general purpose are known as bank cards. Master card, visa maestro, etc., are some of the examples of bank cards. The bank charges annual fees, sets the credit limit and the terms and conditions.

(b) **Travel and Entertainment Cards**

The cards used for paying travel and entertainment expenses are known as travel and entertainment cards. For example, American Express of Diner's Club.

(c) **Company or Retail Store Cards**

The cards used company or retail store cards.

2. **Debit Cards**

The credit cards and debit cards look alike and provide similar benefits but are very different from one another. The credit card is a 'pay later' and the debit card is the 'pay now' card. The customers own account is debited when the debit card is used. Debit card does not facilitate credit facility.

The debit card is used by customers who are not willing to go in debt for meeting their wants. The debit cards do not incure bills or charges and limit the customer expenses to their account balance.

Basically, debit cards follow two types of payment systems i.e., signature based or 'PIN based' transaction.

The PIN is entered and the machine automatically calls the banks checks the customers account balance and deducts the balance with the transaction values. The PIN is only known to the user and his bank.

3. Other Payment Channels/Products

These include the following,

(a) Automated Teller Machines (ATMs)

The customers even today value cash payments for various transactions. Therefore, the cash is being distributed on a regular basis through Automated Teller Machines (ATM). The credit card and ATM card networks are linked and these facilities can be enjoyed by their users. There has been a huge increase in the number of ATM machines in India. ATMs have increased from 35,000 in March 2008 to 44,000 in March 2009.

The ATMs have gained huge popularity in the recent year most banks have installed large amount of ATM machines to facilitate their customers and provide value added services such as funds transfer, bills payment etc.

(b) Mobile Banking

The banks also use mobile as a mode for transactions. Mobile banking facilitates payments of small-value with relatively low fees and are therefore being used by customers in developing countries. There are two models for operating mobile banking. They are the bank-led and the telecom-led models. The countries having small number of banks use telecom-led mode. In India the bank-led model is used.

The RBI issued guidelines for mobile banking transactions. They are,

(i) A approval must be taken from RBI before providing mobile banking facility to customers.

(ii) The facility should be provided only in Indian rupees.

(iii) The banks should accept the prescribed technology and the safety measures and limits set.

(c) Prepaid Payment Instruments

The prepaid payment instruments refer to the smart cards, magnetic strip cards, internet accounts, internet wallets, mobile accounts, mobile wallets etc. The values are stored in advance in such cards and debited once its used. The amount of value stored is the value either paid in cash, debit or credit by its holder. These instruments are convenient to use and are risk-free.

3.3.3 National Electronic Funds Transfer – Definition, Components and Procedure

Q18. Write about Electronic Clearing Service (ECS). Discuss its components and steps.

Answer :

Electronic Clearing Service (ECS)

The interest/dividend payments that occur on a regular basis require expensive- based printed warrants, by post dispatching and reconciliation by agency banks after repayment. It involves problems such as,

- Expensive machinery for printing, dispatching and reconciliation.
- Handling of large number of instruments and immense load on the cheque processing system.
- Chances of fraud and loss of instruments in transit.
- Keeping track of receipts and depositing receipt on the day it is received.
- Processing of cheques cause problem to the cheque clearing system.

To overcome these problems the electronic clearing system is used. This system efficiently handles bulk payments and bulk receipts. The ECS is growing at a rapid rate. In 2009 this facility was available in about 75 major centers.

The ECS is beneficial for both the organization and the customer. The following are the benefits of ECS to organization and customer.

Organization

The benefits of ECS to organization includes,

- It reduces the costs by eliminating the need for printing, MICR format papers and dispatching.
- Eliminates the risk of lost of instrument in transit and fraud.
- Facilitates automatic reconciliation of transactions. Once the ECS cycle is completed the electronic data file is generated by the bank to the user institution.
- Requirement of cash on particular data simplifies the cash management process.
- Enables the company to pay its investors/ shareholders in a world class pattern.

Customer

The benefits of ECS to customer includes,

- The payment can be made on due date.
- Easy receipt of dividend/interest.
- Elimination of problem of loss of instrument in transit and fraud.

Components of ECS

The following are the three components of Electronic Clearing System (ECS),

1. ECS (Credit)

This component facilitates bulk payments. It enables the institutions to make payments to large number of customers. For example: Payments of salaries, to employees or payment of interest to debenture holders etc. The payment amount is remmited to the beneficiary account and the paying institution's account is debited. Keeping every individuals beneficiaries bank account details is very important.

2. ECS (debit)

This component facilitates bulk receipts. It enables the institutions to collect receipts in bulk from several customers. The receipt amount is credited to the institution's account and the amount from the accounts of customers making the payments is debited. Automatic debiting of payment from customer's banks facility is also available.

3. ECS (Centralized)

The NECs is the third party facility that is centralized and located at Mumbai Reserve Bank. The NECS (credit) and NECS (debit) provide facilities similar to ECE (credit) and ECS (debit).

Steps in ECS

The following steps are involved in the functioning of ECS systems,

Step-1

First the payment data, that includes the details of large number of customers/ investors to whom the payment is to be made, is prepared by the user on magnetic media and submitted to his banker.

Step-2

This data is then presented to the local banker's clearing house by the sponsor bank. Upon presentation it is authorized by the clearing house manager for debiting sponsor's bank account and crediting the bank accounts of beneficiaries to whom the payment is to be made.

Step-3

After receiving authorization the data is processed and settlement of inter-bank funds is worked out by the clearing house.

Step-4

Branch wise credit reports are then published and delivered to the service branches of destination banks by the clearing house. This report includes details such as account type, account number etc.

Step-5

Lastly, the respective branches are advised by the service branches to credit the account of beneficiaries on specific dates.

Q19. What is Electronic Fund Transfer (EFT) and National Electronic Fund Transfer (NEFT)? Describe briefly about the various participants involved in clearing and settlement mechanism.

Answer :

Electronic Funds Transfer (EFT)

Electronic payment means paying the amount for purchased goods electronically which was developed when guided transmission media were used for transferring information. Electronic Fund Transfer (EFT) is defined as a process of transferring funds electronically from one financial institution to another. This type of electronic transfer started using different electronic devices like computers, telephone devices, electronic terminals, telecommunications devices. This transfer is done for ordering, instructing and authorizing a bank to debit/credit an account.

Electronic fund transfer is different from traditional methods of payment that depends on physical delivery of cash by using physical means of transport.

Advantages of EFTs

The following are some of the advantages of EFTs,

1. It drastically decreases both billing as well as administrative costs.
2. It enhances the cash flow and increases customer retention.
3. It reduces the labour cost incurred while preparing statements and postage.

National Electronic Fund Transfer (NEFT)

NEFT is basically a substitute of EFT system. It can be defined as an electronic based payment system that implements public key structure technology. The major benefit of NEFT is, it ensure that secure transaction is being performed between the communicating parties. NEFT make use of INFINET connectivity option for establishing connection between different branches of a bank so that they can easily perform the process of fund transfer.

Participants Involved in Clearing and Settlement Process

The participants who are involved in clearing and settlement process include the following,

(i) Clearing Corporation

The major responsibility of this participant is to perform post-trade activities executed on a stock exchange. Some of these activities include,

(a) Risk management

(b) Trade confirmation

(c) Trade settlement.

(ii) Clearing Members

The responsibility of these participants is to settle the obligations specified by clearing corporation. This settlement is done on date of settlement by making funds available in the clearing accounts of designated clearing house.

(iii) Custodian

The custodian refers to clearing members but not trading members. This participant is responsible for settling trades on behalf of trading members (only if the clearing members are given the responsibility of settlement of trade). The existence of custodian provides a confirmation specifying whether the settlement of trade is possible or not. If custodian confirms that the trade is going to be settled, then clearing house assigns that particular obligation to the respective custodian.

(iv) Clearing Banks

Clearing banks acts as an interface that connects clearing members and clearing house. The purpose of this connection is to have impact on the settlement of funds. Before, initiating the process of fund transfer, it is necessary for every individual clearing member to create a dedicated clearing account with designated clearing banks. These members make fund available in clearing account depending on their obligation specified via clearing cooperation.

(v) Depositories

The responsibility of depositories is to execute an electronic file for transferring the holded securities from custodian accounts to clearing house or from clearing house to custodian depending on the schedule of securities allocation.

(vi) Professional Clearing Members (PCM)

The responsibility of PCM is similar to that of custodian in situation where in PCM's are involved in clearing and setting trades executed for their respective clients. Apart from this, PCM also take the responsibility of clearing and settling trades of trading members. In such situation, PCMs only have clearing rights but not trading rights.

3.3.4 ATM, Mobile Banking and M Wallets

Q20. Explain the concept of ATM and mobile banking. Write in detail about various issues associated with them.

Answer :

Automated Teller Machines (ATM)

The automated teller machines refers to machines that deliver cash to customer of different banks and different countries. The automated Teller Machines are linked over the networks. The ATM and credit cards are linked over the network and facilitates the VISA and Master Card holders to withdraw cash from ATMs worldwide. ATMs have gained importance as most of the customers even today prefer cash payment for certain transactions. The non-banking organizations are also developing ATM networks. Therefore, the ATM networks are expanding rapidly.

In India the about 9000 ATMs have been setup within span of one year from 2008-2009. On the other hand the amount of transactions have increased from 17797 lakh transactions to Rs 4,38,151 core in 2007-08 to 23,530 lakh aggregate to Rs. 6,16,456 core during 2008-09.

The banks are also focusing on providing other facilities over the ATM networks. Most banks in India have introduced facilities such as, fund transfer, bill payment services, mobile phone recharge, etc.

Mobile Banking

The increasing use of mobile phones has led to the introduction of mobile banking. The developed countries provide the mobile banking services for payment of small value transactions at low cost. The mobile banking consists of two types of models. (a) The bank led model (b) The telecom led model. In India the bank-led model is used. The countries which don't have a wide spread banking network may use the telecom-led model.

Guidelines

The guidelines for mobile banking have been issued by the RBI in 2008. The following these guidelines are the featured of,

(a) The mobile banking facility cannot be provided without an RBI approval.

(b) The transactions should take place only in Indian rupees and only for bank's customers or the debit/ credit card holders.

(c) The prescribed technology and security standards should be followed by the banks.

The inter-operatibility is mandatory among the service providers according to the guidelines. This is to eliminate the monopolistic practices of certain operators.

Issues Related to E-Banking (ATMs and Mobile Banking)

The modern services, such as ATMs and mobile banking, provided by banks involve various security issues. Eventhough they provide many convenient facilities the following are the issues related to them,

1. Identity Thefts

The user name and password tend to be the identity of an individual in a virtual world. The misuse of individuals personal data another individual for the purpose of fraud is known as identity theft. Usually the ATM transactions are affected by this issues.

2. Carding/ Skimming

The fraudsters usually buy and sell the information relating to stolen bank accounts, card numbers, personal profiles etc., over the carding sites. This is known as carding.

The clonning of electronic data from a payment card without the knowledge of its owner is known as skimming. Usually, it is done by installing a copying device within the card slot of the ATM. This devices stores the card details.

3. **Phising**

This is one of the popular term being used today. Phising refers to illegally capturing and recording the security details of the customer. These details are later used in a fraudental manner. Phising has led to losses of large amounts. An Anti Phising Working Group (APWG) has been set-up to overcome the various phising techniques.

4. **Mules**

The individuals recruited over the internet to act as intermediaries for illegally earned funds are known as mules. The phising or other methods or scan may be used for obtaining these funds. Mule is the name given by Smugllers to individuals that move their illegally acquired fund. Mules are not innocent people they are individuals who volunteer for this purpose willingly.

Q21. Discuss in detail about M Wallets.

Answer :

Mobile Wallets (M Wallets)

Mobile Wallets (M Wallets) is a technique of payment through mobile phone wherein the user of the mobile opens a mobile wallet account in a partner bank and deposits some amount of money for future use. For creating this mobile account, the requirements are mobile number and Mobile Money Identification (MMID), bank name and account number. The mobile number is registered by the issuing bank and it provides a mobile wallet account number to the customer. By using this account, the users cans start doing transaction immediately from anywhere and anytime. While making payment, the user need to enter the wallet account number in the mobile phone and send it to the bank by way of SMS. Then the bank verify the available balance in the mobile wallet account of the user and if the balance is sufficient, then the amount will be debited from the user mobile wallet account. Only the registered mobile phone of the user must be used for each and every payment. The user will get a payment confirmation notification from the bank after the successful completion of transaction. By using mobile wallet payments, two different holders of mobile-wallet account can transfer money from one account to another account. Mobile wallets are announced by RBI certified non-bank entities or banks.

Types of Mobile Wallets

Mobile wallets are of two types. They are,

1. Open loop
2. Semi-closed loop.

1. **Open Loop**

Cash with drawls are permitted in open loop type of wallet, where it is an integration of both mobile banking and mobile wallets.

2. **Semi-Closed Loop**

Cash with drawls are not permitted but cash payments are acceptable in semi-closed loop where bank account is not required.

Process of Mobile Wallet Transactions

The following steps are included in the process of mobile wallet transactions.

Step-1

A software is downloaded by the shoppers in their mobile phone which is connected to their debit card or credit card.

Step-2

After that, if the shoppers are checking out in a store they can use their mobile phone to complete the sale by placing it against a scanner.

Due to large number of mobile wallets, no one is market leader, so the retailers are facing a problem. Hence, the retailers should maintain numerous mobile wallet accounts by downloading different software on their sales terminals and probably encouraging to have new hardware also. Some retailers may feel like they are burden with lot of work for figuring out all those details. But, as per some experts, mobile wallets provide many benefits i.e., from attracting customers to gathering useful data about the purchases of the person. At present various technologies are coming into existence and enabling providers of mobile wallets to work effectively. It is necessary to have additional hardware for some mobile wallets.

Example

Google wallet app make use of a technology called near field communication which needs their customers to click their mobile on a special reader to have a transaction.

3.3.5 Net Banking/Online Banking

Q22. Explain briefly net banking/online banking. What are the advantages and disadvantages of net banking? *Model Paper-III, Q8(b)*

OR

Explain the problems and prospects of net banking. *May/June-13, Q4(a)*

(Refer Only Topics: Disadvantages/Problems of Net Banking/Online Banking, Advantages/Prospects of Net Banking/Online Banking)

OR

Explain the problems and prospects of interest banking.

(Refer Only Topics: Disadvantages/Problems of Net Banking/Online Banking, Advantages/Prospects of Net Banking/Online Banking)

Answer : *May/June-12, Q4(b)*

Net Banking/Online Banking

Online banking may be defined as a "Procedure that allows individuals to perform banking activities from home or the roads using an internet connection". Online banking is also known as e-banking, cyber banking, virtual banking or home banking. Some of the traditional banks also offer online banking facilities such as ICICI bank, State Bank of India etc. Also there are some other banks which do not have any physical identity, but they provide online services. Online banking enables customers to perform all routine transactions, such as account transfers, balance inquiries and bill payments. Some of the banks even offer online loan and credit card applications. It also allows the user to access an account information at any time (i.e., 24 hours a day, 7 days in a week and 365 days in a year).

Online banking uses today's computerized technology in order to bypass the time consuming process of traditional banking and to manage public finances more quickly and efficiently. The customer has to just register himself/herself for one of the online programs introduced by a bank i.e., they have to provide ID and fill a form at any of the bank's branch. In case if a person or his/her spouse wishes to view and manage their joint account online, in such a case they have to sign a durable power of attorney then only the bank will display their holdings together.

One information has been entered, it doesn't need to be re-entered again and again and all the future payments will then take place automatically. Most of the banks even offer job vacancies on their sites, thus giving employment opportunities to educated youth.

Advantages/Prospects of Net Banking/Online Banking

The following are the advantages of online banking,

1. 24 Hours Access

Unlike traditional banks, online banking sites never close, (they are available 24 hours a day, seven days a week, 365 days in a year).

2. Automatic Transfer of Funds to Pay Bills

Electronic payments from accounts are usually credited the same day or the next. Electronic payment of bills involves very less expenses when compared to the postage involved in sending out large number of payments every month.

3. Offer Sophisticated Tools

Most of the online banking sites are now offering advanced tools which includes account aggregation, stock tenders and portfolio managing programs that helps the user (customer) in managing one's assets more effectively.

4. Import Account Transactions

Account transactions can easily be imported into money management software such as Quicken and Microsoft money.

5. Balance Accounts

Even if an individual fails to record ATM withdrawals, e-banking may help them to get arranged. Users can simply copy the transactions and import them into check registers.

6. Cost Reduction

Online banking reduces the cost of creating, processing, distributing, storing and retrieving paper-based information. High printing and postage costs are also reduced or sometimes eliminated.

7. Helps in Viewing the Images

It helps in viewing the images of bill statements, cheques and deposit slips.

8. Account Aggregation

It gives an opportunity to the individuals to view balances and market value of online accounts held at other institutions including investments, credit cards, reward programs etc.

9. Access Account History

It helps the user in accessing account history (i.e., deposits and withdrawals made by him in a month or in a year).

10. Transaction Speed

Online banking sites generally accomplish and confirm the transactions faster than the ATMs.

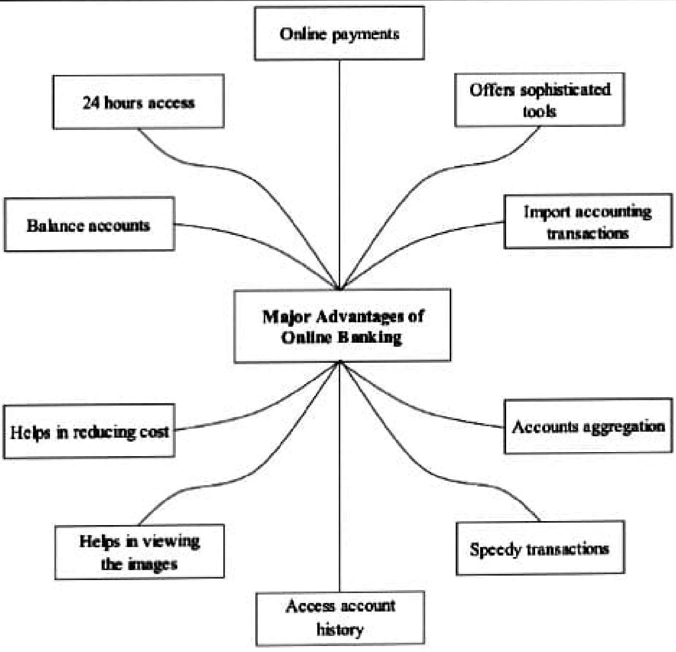


Figure: Advantages of On-line Banking

Disadvantages/Problems of Net Banking/Online Banking

The following are the disadvantages of online banking,

(i) In order to get registered with an online bank program, one has to provide his/her ID, and fill up the entire form at bank branch which may take some time.

(ii) Even the largest banks repeatedly change their online programs adding new features to the unfamiliar places.

(iii) When an account holder pays online, he/she has to put in a cheque request as much as two weeks before the due date of payment.

(iv) The biggest problem with online banking is learning to trust it. Most of the times an individual may be in a dilemma whether his/her transaction has gone through or not, whether he/she pushed the transfer button once or twice.

(v) It is difficult or impossible for online-only banks to offer some services such as travellers cheques and cashier's cheques.

Online-only Banks

Banks which do not have any physical presence, i.e., all banking transactions are done online only.

Tips for Safe Banking Over the Internet

The following are the tips provided for safe banking over the internet,

1. Always confirm whether an online bank is authentic and that your deposits are safe.
2. Keep all your personal information private and secure.
3. Always understand your rights as a consumer.
4. Always go for more assistance from banking regulators.
5. Read key information i.e., terms and conditions about the bank first, which are frosted on its website.
6. Always watch out for copycat (fraudulent) websites that uses a name or web address similar to others.
   Copycat refers to An Informal person who copy others, intimation.
7. Always verify your bank insurance status.

Conclusion

Banks have spent generations to gain the trust of their customers. So, the biggest challenge for banking industry is to design their services in a way that it should give satisfaction to its customer and one should readily learn to use and trust it.

Q23. What are the different types of Electronic Payment Media (EPM)?

Answer :

Electronic payment media can be grouped into three types depending on information being transferred on-line. They are,

1. Banking and financial payment
2. Retailing payment
3. On-line e-commerce payment.

1. Banking and Financial Payment

The banking and financial payment system is again classified into three types. They are,

(a) Large-scale payment

(b) Small-scale payment

(c) Home banking.

(a) Large-scale Payment

Bank-to-bank transfer is a good example for this kind of payment where the funds flow from one bank to another instantaneously.

(b) Small-scale Payment

ATM's and cash dispensers are examples for this kind of payment using ATM, a customer can withdraw money from anywhere at anytime.

(c) Home Banking

Home banking service can be classified into three types.

(i) Basic services include personal finance service

(ii) Intermediate services include financial management

(iii) Advanced services include trading service.

2. Retailing Payment

Retailing payment is classified into three types. They are,

(a) Credit payment

(b) Debit payment

(c) Charge-card payment.

(a) Credit Payment

If a customer purchased any product or service using credit card then, he simply transfer his card details to the service provider and then the credit-card company processes transaction.

(b) Debit Payment

In this type of retailing payment the customer pay in advance for enjoying the privileges of information to be retrieved. Examples for such prepaid payment system is electronic purses.

(c) Charge-card Payment

Example of charge-card payment include American Express. Charge-card is a way of getting a short-term loan for a purchase. It is similar to credit card, except that the customer make an agreement with the financial institution that he will pay some fixed charges to it each month.

3. On-line E-commerce Payment

On-line payment system is classified into two types. They are,

(a) Token-based payment system

(b) Credit-card based payment system.

(a) Token-based Payment System

The three different types of token-based payment are,

(i) E-cash

(ii) E-check

(iii) Smart cards.

(i) E-cash

It is a form of digital cash which provides a high level of security. It also reduces the overhead of paper cash.

(ii) E-check

E-check is another form of electronic payment system. These checks are preferred when a customer is willing to make a payment without using paper currency.

Example: Net cheque, net bill.

(iii) Smart Cards

Smart cards are similar to debit/credit card but with enhanced features such as micro processor that have the ability to store massive amount of information which is 80 times greater than conventional, magnetic strip cards.

Example: Mondex electronic currency card.

(b) Credit-card Based Payment Systems

The different types of credit-card based payment systems are,

(i) Plain credit-card payment system

(ii) Encrypted credit-card payment system

(iii) On-line third-party credit-card payment system.

(i) Plain Credit-card Payment System

In this type of payment system, the credit-card transaction is provided without using any encryption techniques. It is one of the simplest form of payment system.

(ii) Encrypted Credit-card Payment System

In this type of payment, credit-card is encrypted before performing any transaction using various encryption schemes like Privacy Enhanced Mail (PEM) and Pretty Good Privacy (PGP).

(iii) On-line Third-party Credit-card Payment System

Security and verification can be provided by using third-party, which is a company that gathers and verifies the payment of funds that flow from one party to a another.

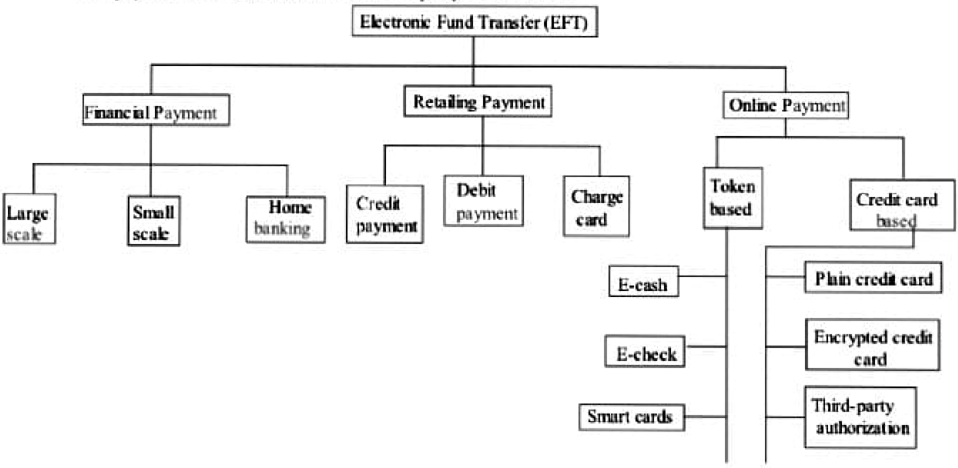


Figure: Types of Electronic Payment System

3.4 BANCASSURANCE

Q24. What do you mean by term bancassurance? Write about its role in banks, insurance companies and customers.

Answer : *Model Paper-I, Q8(b)*

Bancassurance

The distribution channels set-up by banks for the purpose of selling insurance products is known as Bancassurance.

The 'bancassurance' is a French term which was first introduced in 1980. Earlier French banks sold more insurance policies. However, the selling of insurance policies by banks became a common practice in most of the European countries and the United States. This practice was adopted even by most of the Asian Banks.

The increased population in India and a wide network of banks with low insurance penetration forced the Indian banks to enter into the insurance business.

Under the Malhotra committee recommendations the government of India Under Section 6(1) (0) of the Banking Regulation Act, 1949 permitted the banks to sell insurance.

Bancassurance Role in Banks

The bancassurance plays a vital role in banks and help them in following ways,

1. Increased competition has led to restricted 'spreads' or Net Interest Margins (NIMs) for banks. The banks are therefore shifting towards, alternative source of income. This includes fee-based income.
2. Bancassurance ensures growth in earnings and absence of problem of NPAs.
3. Low amount or no investment in infrastructure is required for banc assurance.
4. Large network of banks enable the banks to benefit from low insurance penetration and density and generate a high income.
5. The banks can interact with the customer's face-to-face and design and market insurance polices in accordance with the customer requirements.
6. The addition of insurance policies to banking operations enable them to divide their incomes and at the same time increase their assets.

Bancassurance Role In Insurance Companies

Bancassurance also helps the insurance companies. It helps the insurance companies in following ways,

1. Increased competition has led to the introduction of huge foreign insurance companies in both life and non-life insurance sectors. Therefore, they have established joint ventures with Indian companies. There has also been an increase in the number of distribution channels.
2. The premium earnings of banks has increased considerably forms 7.97 percent in 2007-08 to 9.69 percent in 2008-2009.
3. The insurers were able to get a lunge a huge base by forming collaborations with private sector banks.
4. There was no need to train large number of insurance agents as the available bank staff was available for training. On the basis of client data available with the banks the insurer's own agents were able to utilize it.
5. The interaction of bank staff with customers could help them introduce and improve policies as per the customer requirements.
6. Insurance companies are to acquire certain amount of revenue from social sector as per IRDA norms. Therefore, rural banks enables them to achieve this goal cost effectively.

Bancassurance Role in Customers

Customer's benefit from bancassurance in the following ways,

1. Bancassurance provides increased trust in insurance policies, to customers, as they are in relationship with banks for a long time.
2. Customers get access to different financial services at single place.
3. Single financial supermarket provides better deals to customers with relation to financial products.
4. The customers get better guidance from banks due to the financial supermarket concept.
5. The one stop shop provides cost effective products to customers.
6. The customers get free financial advise from the bankers as the relationship between them is different from the relationship between the insurer and customer.

Q25. Write in detail about various models of bancassurance. Discuss its practices adopted by various countries.

Answer :

Models of Bancassurance

The bancassurance models differ from one another. The following are the three basic bancassurance models,

1. The Referral Model

This model is very less risky for banks. The banks forward their customer database or client database to the insurance company for commission. The insurance company or its agents directly contact the clients and strike the deals.

2. **The Corporate Agency Model**

In this model, the banks act as the agent. The bank staff is provided training for dealing with the sole of insurance products and understanding the customer needs for insurance. This model generates higher commission to the banks, than the referral model. This model also involves risk such as loss of bank reputation in case of failure of staff to provide proper advice or the services of specially trained staff may be required for managing the business or selected employees may resist to change in portfolio. But appropriate training and incentives can make this model a success.

3. **The Fully Integrated Financial Service Model**

This model treats the insurance as just another business for bank. The banks should be owing the insurance subsidiaries. The ownership may either be with or without the participation of foreign firms. This model has been successfully established and being run by banks such as SBI, ICICI bank and HDFC bank. The banks have received the synergy and economies of scope benefits from this model. The integrated financial service model has also proved to be successful at the international level.

The referral agency model and the corporate agency model are the current trends in India. The banks can select to become either the referred providers or corporate agents as per the existing regulation. They can do this either for one life or non life increase company India.

Bancassurance Practices Adopted by Different Countries

Different practices adopted by different countries with relation to,

1. **Ownership**

Certain countries practice independent ownership and operations, whereas, subsidiary and joint venture may also be practiced and permitted in other countries.

2. **Point of Sales**

The insurance agents that exist within the bank branch sell the insurance.

- Either the bank itself may possess license to sell the insurance.
- The bank staff may be trained and qualified to sell the insurance.
- Direct mailing, internet, branches and other distribution channels may be used for sale of insurance.

3. **Products**

Opportunity based simple products are sold.

- Simple products in addition with bank offers are sold.
- Intensive products on the basis of customer advice are sold.
- Financial products associated with life cycle/ important events of customers are sold.

4. **Client Database**

The banks may not share the complete customer database. Banks share the complete database with their insurance clients.

5. **Product Supplier**

Bankassurer manufactural products are supplied. Product supplied by single or multiple suppliers are distributed by banks.

6. **Policy Administration**

Insurance partner does the policy administration.

- Insurance subsidiaries deal with the policy administration.
- The policy administration is handed over to the third party.

3.5 PAYMENT AND SETTLEMENT SYSTEMS IN BANKS - CLEARING

Q26. Discuss in detail about the payment and settlement systems in banks.

Answer :

Generally, the central bank of any country is responsible for the development of national payment system. In India, Reserve Bank of India (RBI) is playing this role for developing a secure, safe, sound and efficient payment system.

A payment system is a method which promotes transfer of value between the payer and beneficiary. A two-way flow of payments in exchange of goods and services is acceptable in payment system. Payment systems comprises of instruments used in making payments, rules, regulations and procedures which are regulating these payments, organizations that promote methods of payment and legal systems which are introduced for promoting fund transfers among various participants.

These payment systems are useful for banks, governments, companies, individuals etc., for making payments to one another.

In Indian, payment can be done in many ways. They are, cash, demand draft, cheque, debit cards, credit cards and by giving electronic instructions to the banker who is going to make that payment instead of his customers. Electronic payments can be carried out through EFT, ECS and RTGs. Even some banks are providing banking services by means of internet for promoting electronic transfer of funds.

Payment Through Cheque

The payments which are made through cheque begins, when personal cheque of the payer is given to the beneficiary. The receiver of cheque is supposed to deposit the cheque in the bank account for getting actual payment funds. By internal arrangement of bank, the funds are credited into the beneficiary account if he/she is having his account in the same bank and in the same city or otherwise the banker will collect the funds from payers banker by way of a clearing house.

Clearing House

It is an organization of banks which promotes payments made by means of cheque among various branches of bank within the place or city. For exchanging the cheque drawn on one another and for claiming funds, clearing house becomes a central meeting place for bankers and these type of functions are called clearing operations. Usually, one bank is made as in-charge of all clearing operations, at present Reserve Bank of India is managing all the operations of clearing house in four metro's and few major cities. RBI provides some rules and regulations to the clearing house for performing its operations effectively. Around the country, there are more than a thousand clearing houses functioning to promote cheque payments which are controlled and managed by RBI, SBI and other public sector banks.

Clearing Process

Usually, it will take upto 2-3 days time if the cheque is paid within the same city and it will take upto 3-10 days, if cheques are from other cities. A system called high value clearing is available in few big cities for promoting the completion of cheque clearing cycle on the same day and the customer who is depositing the cheque is allowed to use the proceeds of cheque next day morning. If banks are not clearing the cheques before the normal period, then the banks are supposed to compensate the loss of their customers.

Clearing Charges

If the beneficiary wants to realize the funds from bank, he/she should incur some charges. If it is a local cheque i.e., within the same city, then no charges are imposed or otherwise, the bank will take some processing/collection charges based on the amount of cheque and the place from where it has to be realised. The Indian Bank's association or banks themselves will decide the charges imposed by the banks. The schedule of service charges should be published by the banks.

Payments Without Use of Cheque and Cash

Without using cheques, the payments can be carried out between two or more parties by way of electronic instructions. Electronic funds transfer, electronic clearing service, credit/debit cards etc., are the retail payments mechanisms which can be used to make payment.

Role of ATM's in Payment and Service Process

ATM's will provide the facilities like cash withdrawal, paying of utility bills, balance enquiry, transfer of funds between accounts, deposit of cash and cheques into accounts and many other banking transactions.

Role of Credit/Debit Cards in Payment Systems

Now-a-days, credit/debit cards are used all over the country as they offer an appropriate way of making payments for goods and services without cash or cheques. Credit cards are issued by the banks to its customers. The retailers who are accepting credit/debit card payment will be able to claim the amount from the customer's bank through his own bank.

Q27. Explain the credit card operations.

Answer :

The reserve bank has initiated the working group of regulatory mechanism for credit cards. Reserve Bank recommended several regulatory measures which promote safe, secure and efficient progress of credit cards.

It also make sure that the rules, regulations, standards and practices of the card issuing banks are in a position to set best customer practices.

RBI has formulated the guidelines on credit card operations on the basis of suggestions given by the group and also the feedback from the public, card issuing banks and others. RBI has suggested all credit card issuing banks or Non-Banking Financial Companies (NBFCS) to follow these guidelines as soon as possible. These banks must have a effective documented policy and a fair practices code for credit card operations and must spread its contents by their websites, etc.

Issue of Cards

The banks or NBFCS must make sure the following points during the issue of credit cards,

1. Evaluation of credit risk is done independently when credit cards are issued to students and others with dependent financial means. Additional credit cards can issued only if the liability is borne by principal card holder.
2. The maximum limit of the credit card for the holder must be evaluated by considering the credit limits on credit cards issued by different banks and depending on self credit information.
3. The card issuing banks/NBFC's are alone held responsible for fulfilling the requirements of know your customer (KYC), even if agents do business on their behalf.
4. The issuers of credit card should follow simple and clear language while providing terms and conditions regarding issue and usage of the credit card to the user. Most important terms and conditions must be highlighted.

Interest Rates/ Other Charges

The issuers of the card must make sure that,

1. Discharge of bills must be on time.
2. Annualized Percentage Rates (APR's) are specified on card products and the procedure for APR computation and the late payment amounts must be clearly mentioned.
3. Specify the payment terms and conditions of credit card due along with the minimum amount due inorder to make sure that there is no negative payment.
4. If any changes are made in charges apart from interest then notice should be given to the customers atleast before one month.

Billing

1. The issuing bank/NBFC must verify that bills that are raised and issued to customers must not have any error.
2. The card issuing bank must give explanation and if possible documentary proof to the customers within 60 days if any wrong bill is issued.
3. The issuers of credit card must provide bills and statements of accounts online inorder to prevent regular complaints.

Direct Selling Agents (DSA's)

1. The banks/Non-Banking Financial Companies (NBFCs) must be very cautious when various credit card operations are outsourced because the appointment of such service providers should not effect the quality of customer service.
2. The card issuers must make sure that the DSAs will not reveal the records of the customers, value the secracy of customer and follow fair practices in debt collection.

Customer Rights (Right to Privacy)

The credit card issuing banks/NBFCs must make sure that,

1. Cards should be issued untill request is made by the recipient.
2. Even loans or other credit services must not be provided to the customers of credit card unless they make a request.
3. Credit cards are not updated and increased in credit limits independently.
4. A Do Not Call Registry (DNCR) facility is maintained to avoid marketing calls or SMS to customers and also non-customer phone numbers who are not interested.

Debt Collection

1. At the time of collecting dues, the banks/NBFCs must make sure that they and also their agents must follow the instructions of RBI on fair practices code for lenders and also their own code for collection of dues.
2. During the appointment of third party agencies for debt collection, the issuers of credit card must make sure that the agents are following strict customer privacy and does not involve in any action which may damage their reputation and integrity.

Grievance Redressal

1. Duration of sixty days must be provided to the customers for mentioning their grievances/ complaints.
2. An internal grievance redressal machinery should be initiated by the card issuing banks/NBFCs and public it by electronic and print media. The procedure and time fixed for responding to the complaints of customers regarding grievance redressal must also be uploaded on the website.

Monitoring

1. On monthly basis the operations of credit card containing reports of defaulters to CIBIL and credit card related complaints should be reviewed by the banks/NBFCs and their standing committee on customer services.
2. Banks should conduct a detailed quarterly analysis relating to credit card complaints and present it to top management.

Penalty

Under the provisions of the Banking Regulation Act, 1949 the reserve bank has a right to charge penalty if any guidelines are violated by bank/NBFC.

Q28. What is the role of RBI in payment systems? Explain the major developments of payment and settlement systems in India in the past decade.

Answer :

Role of RBI in Payment Systems

The Reserve Bank of India (RBI) play different roles beside being a regulate and supervise of payment systems, it also acts as a settlement bank. RBI is planning to establish new methods which are more organized and safe in effecting payments in the country on an ongoing basis. A new system of Magnetic Ink Character Recognition (MICR) has been established by RBI as cheque clearing during 1980's for 4 metropolitan cities like Mumbai, New Delhi, Chennai and Kolkatta. Electronic Clearing Systems (ECS) and Electronic Fund Transfer (EFT) the electronic payment systems which were introduced during the mid 90's. RTGs was introduced during 2004-2005. Inorder to increase the proficiency and to fulfill the necessities of customers, RBI have advanced/ upgraded the already existing system constantly. By upgrading the technology, RBI is also taking some further safety measures in these systems to protect them and to hold the integrity of such transactions.

RBI Acts as a Regular of Payment System

RBI has Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) as a sub-committee of its central board which is highest policy making body on payment system. National Payments Council (NPC) provide support to the board by providing efficient professionals in the field as members. It is held responsible to authorize, decide policies and make standards for present and future payment systems.

Payment and Settlement Systems in India in the Past Decade

Many, payment system services are being offered by banks during last decade to both ordinary individuals and organizations which have improved considerably. It is because of advanced technology application in delivering the services and because of procedural changes made as a result of competition between the banks. The following are the changes available in this system,

1. There is immense development/growth in the cheque clearing system. At present, it takes only 2-3 days for collecting local cheque i.e., within the city and bank. In 42 big cities automated cheque processing centres are introduced wherein the cheques received by all bank branches in the city are processed at night. Previously, the time taken for collecting outstation cheques was 10 days or more but at present it takes only 4 to 10 days based on the place of paying centres.

2. In 1990's they have introduced some variety of electronic payment products. Big organizations are taking help from Electronic Clearing Service (ECS) for paying dividend, interest and refunds electronically on the due date. During 2005-06 36 million transactions were carried out through ECS which shows the extent of savings.

3. The scenario of money transfer has been changed by the development of Electronic Funds Transfer (EFT) facility through banks. A same-day funds transfer facility has been started by the commercial banks to their customers with the EFT infrastructure introduced by the Reserve Bank of India (RBI). A special-EFT which is a variety of EFT was designed mainly for the bank branches which assists in transferring funds on the same day within the closed group of systemized and networked branches situated anywhere in the country.

4. A system was introduced by RBI called Real-Time Gross Settlement (RTGS) which is an extension to EFT scenario. Organizational bodies and other bank customers has the facility to transfer funds immediately to designated branches. As per operating rules of RTGs, if the credit is not used it should be refunded within 2 hours.

5. Installation of ATMs has been developing rapidly all over the country and the customers can operate their accounts for the purpose of cash withdrawal, balance enquiry, issue of stop-instruction, requisition of cheque books, deposit of cash etc on 24×7 basis through ATMs. Around 16,000 ATMs are operating in the country and it is increasing every month.

6. The growth in use of debit cards and credit cards for payments has been increasing from the last three to four years in the country. There are 4.33 crore payment cards till December 2004 in the country. This is not only due to security and flexibility but also because of retail banking development in the country.

Q29. Elucidate the vision document for payment systems in 2005-08.

Answer :

The important points relating to payment and settlement systems 2005-2008 which was framed in the vision document of Reserve Bank of India are discussed below,

First Year i.e., 2005-2006

The focus of first year will be on,

1. National settlement systems were operationalized for all clearings at four metro cities by December 2005.

2. To form a national level entity which can mange all retail payment systems they are following the Indian Banks Association and major banks.

3. The guidelines/regulations regarding the proposed Electronic Funds Transfer (EFT) are finalized.

4. The stage-2 of RTGs system is implemented i.e., Integrated Accounting System (IAS) for settling all interbank transactions on platform of RTGs and for closing the paper based inter-bank clearing.

5. On pilot basis, image-based Cheque Truncation System (CTC) at National Capital Region (NCR) is implemented.

6. Standard of minimum efficiency is prepared at MICR Cheque Processing Centre (CPC).

7. EFT facility is offered at 500 capital market intensive centres recognized by both NSE and BSE.

8. Building Customer Facilitation Centre (CFC) at Reserve Bank for different levels of national payment systems.

9. Designing the red book on payment systems in India, and

10. Designing a universal legislation on payment system.

Second Year i.e., 2006-2007

In second year, it is predicted to,

1. Completing the tasks which were started in 2005-06.
2. Increasing MICR clearing to 20 extra recognized centres.
3. Make sure that each cheque issued must comply with the MICR format and standards.
4. Developing Electronic Fund Transfer (EFT) systems at national level by the new retail payment centre.
5. All payment systems in India are made to follow the basic principles for Systematically Important payment Systems (SIPS).
6. Electronic mode is used for payments and receipts of government.

Third Year i.e., 2007-2008

In third year, it would control on,

1. Regulation of different payment systems.
2. Generating off city back up arrangement for high value national payments systems like RTGs and Gsec clearing.
3. Allowing cheque truncation based clearing at Mumbai, Kolkata, Chennai and also including national settlement system at all big clearing organizations/houses in country.

3.6 GATEWAYS – RTGS AND SWIFT

Q30. Define Gateways. Write in detail about RTGs and its impact on the financial sector.

Answer : *Model Paper-II, Q8(b)*

Gateways

Gateways simply refers to the payment gateways which facilitate or provide merchant services through E-commerce applications which gives authorization of payment processing.

Real Time Gross Settlement (RTGS)

RTGS means Real Time Gross Settlement. RTGS system is a quickest funds transfer process where money is transferred on a "real time" and on "gross" basis from one bank to another. Settlement in "real time" implies that payment transaction does not involve any waiting period, it is settled soon after its processing is done. When transaction is carried out on one to one basis without bunching with any other transaction it is called "Gross Settlement". The payment is considered to be final and irreversible as the money transfer occurs in the books of the RBI.

RTGS vs Electronic Fund Transfer System (EFT) or National Electronics Funds Transfer System (NEFT)

The EFT and NEFT are electronic fund transfer medium which are functioning on a Deferred Net Settlement (DNS) that settles transactions in batches. The settlement in DNS occurs at a specific point of time. Until that time, all transactions are delayed. For instance, during week days, NEFT settlement occurs 6 times and 3 times on saturdays. The transaction which has start after a designated settlement time have to wait till the next designated settlement time. In contrast to this, RTGS transactions are settled any time during business hours of RTGS.

RTGS Transactions

RTGS system is mainly for the transactions of large value. The minimum amount which can be send through RTGS is ₹ 1 lakh. There is no upper limit for RTGS transactions, there is no minimum or maximum limit decided for NEFT and EFT transactions.

Time consumed for Funds Transfer Under RTGS

In normal conditions, the funds are received in real time by the beneficiary branches as soon as they are transferred by the remitting bank. The beneficiary's account must be credited within two hours of receiving the funds transfer message by beneficiary bank.

Acknowledgement of Funds Transfer

A message from the Reserve Bank is send to the remitting bank that the money has been credited to the receiving bank.

Refund of Money in Case of Non-credit to the Beneficiary

The beneficiary's account is credited immediately by the receiving bank. Due to any reason, if the money could not be credited then the receiving bank have to payback the money within 2hrs to the remitting bank. After receiving money from the remitting bank, the original debit entry is cancelled in customer's account.

Availability of RTGS Window to the Customers

The RTGS window is accessible to the customers from 9:00 hours to 12:00 noon on saturdays to carry out customer transactions for settlement at the RBI. The timings between these hours can be alter based on the customer timing of the branches. The service window is accessible from 9:00 hours to 17:00 hours on week days and from 9:00 hours to 14:00 hours on saturdays for inter bank transactions.

Processing Charges/Service Charges for RTGS Transactions

RBI abandoned its processing charges till March 31, 2008 on all electronic payment products. Service charges levied by banks in according to the respective banks. The bank wise details relating to charges imposed are available on RBI website.

Details Required from the Remitter to Carry Out Remittance Under RTGS Transactions

To have effective RTGS remittance, the remitting customer has to provide data to the bank such as, amount to be remitted, account number which is to be debited, name of the beneficiary bank and customer name and account number of the beneficiary customer, IFSC code of receiving bank, etc.

IFSC Code of the Receiving Branch

IFSC code is printed on the cheque leaf or can be taken from her/his branch. The code and bank branch information should be conveyed to the remitting customer by the beneficiary.

Availability of RTGS Services in Branches

More than 26,000 bank branches were RTGS enabled as on January 31, 2007. In India, all the bank branches does not have RTGS facility.

Advantage for Companies

It is estimated that large companies can save ₹ 2,000 per ₹ 1 crore worth of transactions by RTGS. Paper work and risk of country party default is reduced. It enhances investor confidence and assists companies to properly manage their working capital requirements.

RTGS Operations – Impact on the Financial Sector

RTGS provide few important advantages to the Indian financial system,

1. It has increased the stability of the financial system.
2. It has boosted the effectiveness of the system related to,
   - (i) Cash management by banks
   - (ii) Reduction in transactions cost and
   - (iii) Immediate transfer to the customer's account.
3. The time period has been extended for settling inter-bank transactions and changed from the banking hours to the RTGS operating hours of 9:00 hours to 17:00 hours during weekdays and 9:00 hours to 14:30 hours on saturday.
4. RTGS system is also utilized for customer transactions.
5. The minimum and maximum limit is not set till now on customer transactions.
6. RTGS system assures settlement is done in the books of Reserve Bank immediately which develops confidence in the sending bank and the receiving bank that the payment transaction is finalized and the funds can be utilized by the receiving bank instantaneously.

Q31. Discuss in detail about SWIFT.

Answer :

Society for World-Wide Interbank Financial Telecommunications (SWIFT)

SWIFT stands for society for world wide interbank financial telecommunications, which is a cooperative society registered in May 1973 in brussels, Belgium. It is a society of international banks which manages computerized telecommunication system.

At global level, it provides unique message processing services and a quick correct and authenticated transfer of financial messages. SWIFT services facilitates both retail and corporate customers to transfer funds through out the world.

Brief History

Non-profit collaboration of nearly 239 banks of Asia, Europe and North America came forward and made a decision regarding formation of SWIFT. The purpose of the society was to increase the security level of fund transfer transactions, standardize the funds transfer delivery of payment instructions, lower the cost of message transmission payment/settlement system round the clock. Approximately 586 banks were on line on SWIFT system in 1977, at present there are 1859 live participants and 7125 live users with 2288 members in 192 countries.

SWIFT Operations

The basic purpose of society was to standardize formats of routine international transactions. It makes sure that there is uniformity in international standards. The society has created ten categories of message from 0 to 9.

Message Format/Authentication

Every text message is segregated into various parts known as "fields" for easy recognition and to show the particular action related with that part. These fields are categorized as important/mandatory whereas others are optimal. In the PC connected application, every field is recognized by a code work mandatory field/optional field (MF/OF) exhibiting the mandatory optional use of the respected field. Every message consists of a header, message text, authenticator and trails.

Whenever a message is transmitted to the computer, a numerical figure known as "Checksum" is computed by the computer automatically on the basis of mathematical formulae which were fed with the software. As a trailer for each message the computer automatically add "checksum" on receipt at the destination.

The receiving computer automatically verifies it again to assure that the text message has stayed unaltered while transmission.

Bank Identification Code (BIC)

The member banks and their branches associated with SWIFT are automatically allotted particular Bank Identification Code (BIC) so that both sender and receiver can be easily recognized. The BIC is allotted as per the rules and regulations of international chamber of commerce and International Organization for Standardization (ISO).

Message Security

1. High level of security and efficiency is assured by SWIFT i.e, privacy, reliability, accuracy, safety and deliver of messages within fixed time period.
2. A detailed authorization process is there for SWIFT network accessibility by using secret password codes which should be confirmed by every user bank. Every message is allotted with an Input Sequence. No. (ISN) on entry and on exit an Output Sequence No. (OSN) is provided.
3. If this sequence (ISN) is interrupted for any cause, SWIFT rejects the message and displays the message status as rejected, later no action is taken by SWIFT.
4. The messages are encrypted after allotting ISN and transmitted by a system in the form of codes. At the time of receiving, these codes get automatically converted. It ensures that even the SWIFT staff is unaware of the contents when message is flowing through SWIFT system.

Advantages

Following are the advantages of SWIFT. They include,

1. If both sender and receiver are active on SWIFT at same time, a message is delivered in 20 seconds.
2. The message are correct and even checked at the point of receiving.
3. SWIFT manages nearly 220.1 million messages per month, average daily traffic 9081423 of messages globally. High volume assures low cost per message.
4. Globally, SWIFT is the recent mode of inter-bank exchange of messages which is reliable, cost effective and secure communication system. It compensates the bank in condition of misuse of the system. It gives instant transfer of funds, LCs, balance reports, statement of accounts etc. leading to increased customer service, better funds management and lower costs.

SWIFT in India

The idea to bring in SWIFT in India started in 1982 by RBI and Indian Banks Association. The dream became reality when SWIFT was officially introduced on 2nd December, 1991 with constant efforts of IBA. Richard Frohlich was the chariman of Board of Directors, SWIFT made himself accessible to the banking industry in India. In India, 64 financial institutions/banks act on SWIFT. All the major banks are linked by SWIFT because it is not possible for them to respond to current demands of corporate and retail customers who requires services at a fast pace.

SHORT QUESTIONS AND ANSWERS

Q1. NEFT

Answer : *May/June-16, Q1(e)*

NEFT means National Electronic Funds Transfer which is basically a substitute of EFT system. It can be defined as an electronic based payment system that implements public key structure technology. The major benefit of NEFT is, it ensure that secure transaction is being performed between the communicating parties. NEFT make use of INFINET connectivity option for establishing connection between different branches of a bank so that they can easily perform the process of fund transfer.

Q2. What do you mean by core banking solution and innovative banking?

OR

Core Banking Solution *April/May-15, Q1(c)*

(Refer Only Topic: Core Banking Solution)

OR

Innovative Banking

(Refer Only Topic: Innovative Banking)

Answer : *(May/June-13, Q1(c) | May/June-12, Q1(c))*

Core Banking Solution

Core banking solution is defined as the set of robust software components or integration of core banking components that are developed and tailored to satisfy the requirements of the individual businesses in order to face the challengers in the banking sector. The modules of core banking solution include saving bank account, current account, fixed deposits, cash credit, etc., and in addition include ATM and internet banking. While replacing the traditional solutions with core banking solution, banks should follow a holistic approach to minimize and effectively manage the risks associated with it.

Innovative Banking

In India, the banking sector has undergone tremendous changes from the past few years. The implementation of technology leads to the development of new products and services in the banking sector. Innovation mainly deals with introducing new technology, products or services. The key innovations taken place in banking sector are - ATM, telebanking, remote access, CMS, Cards, Net banking, Mobile banking and connectivity. The innovative banking facilitates round the clock service to the customers. It is necessary to have customer education in banking sector as it will be advantageous for banks as well as for its clients.

Q3. Retail Banking

Answer : *(May/June-13, Q1(b) | May/June-12, Q1(d))*

The financial dictionary defines the retail banking as "a retail bank is a bank that caters for ordinary individuals and small businesses, as distinct from large corporations. Retail banking operations offer deposit facilities, lend money, transfer funds and are prepared to deal in relatively small amounts".

Retail banking refers to large scale banking in which branches of large commercial banks are available for use of customers. Savings and current accounts, mortgages, personal loans, debit cards, credit cards and many other services are offered by the retail banks.

Q4. Net Banking *April/May-15, Q1(f)*

OR

E-Banking

Answer : *April/May-14, Q1(a)*

Online banking may be defined as a "Procedure that allows individuals to perform banking activities from home or the roads using an internet connection". Online banking is also known as e-banking, cyber banking, virtual banking or home banking. Some of the traditional banks also offer online banking facilities such as ICICI bank, State Bank of India etc. Also there are some other banks which do not have any physical identity, but they provide online services. Online banking enables customers to perform all routine transactions, such as account transfers, balance inquiries and bill payments. Some of the banks even offer online loan and credit card applications. It also allows the user to access an account information at any time (i.e., 24 hours a day, 7 days in a week and 365 days in a year).

Q5. Advantages of Net Banking

Answer : *(Model Paper-I, Q3 | May/June-17, Q1(e))*

The following are the advantages of online banking,

1. 24 Hours Access

Unlike traditional banks, online banking sites never close, (they are available 24 hours a day, seven days a week, 365 days in a year).

2. Automatic Transfer of Funds to Pay Bills

Electronic payments from accounts are usually credited the same day or the next. Electronic payment of bills involves very less expenses when compared to the postage involved in sending out large number of payments every month.

3. Offer Sophisticated Tools

Most of the online banking sites are now offering advanced tools which includes account aggregation, stock tenders and portfolio managing programs that helps the user (customer) in managing one's assets more effectively.

4. Import Account Transactions

Account transactions can easily be imported into money management software such as Quicken and Microsoft money.

5. Balance Accounts

Even if an individual fails to record ATM withdrawals, e-banking may help them to get arranged. Users can simply copy the transactions and import them into check registers.

Q6. Define plastic money and list out its advantages.

OR

Plastic Money *(April/May-15, Q1(d) | May/June-13, Q1(f))*

(Refer Only Topic: Plastic Money)

OR

Advantages of Plastic Money

(Refer Only Topic: Advantages of Plastic Money)

Answer : *May/June-16, Q1(f)*

Plastic Money

Plastic money refers to the replacement of currency notes into plastic cards. These plastic cards used in place of currency is known as the plastic money.

Plastic money's main objective is to ensure user's safety eliminating the risk of carrying cash. The postponement of actual payment or pre-purchase payment on the card issued are some of the other several objectives of plastic money.

Advantages of Plastic Money

The following are the advantages of plastic money,

(i) It is very useful in emergency situations.

(ii) It helps to make deposits and with drawals on instant basis.

(iii) It ensure's users safety by eliminating the risk of carrying cash.

(iv) It consumes less time to complete a transaction.

(v) It facilitates the storage of maximum amount of money.

Q7. Write a short note on ATM and Mobile phone-banking.

OR

ATM *April/May-15, Q1(e)*

(Refer Only Topic: ATM)

OR

Mobile-Phone Banking

(Refer Only Topic: Mobile – Phone Banking)

Answer : *(May/June-13, Q1(j) | May/June-12, Q1(e))*

ATM

The automated teller machines refers to machines that deliver cash to customer of different banks and different countries. The automated Teller Machines are linked over the networks. The ATM and credit cards are linked over the network and facilitates the VISA and Master Card holders to withdraw cash from ATMs worldwide. ATMs have gained importance as most of the customers even today prefer cash payment for certain transactions. The non-banking organizations are also developing ATM networks. Therefore, the ATM networks are expanding rapidly.

Mobile – Phone Banking

The banks also use mobile as a mode for transactions. Mobile banking facilitates payments of small-value with relatively low fees and are therefore being used by customers in developing countries. There are two models for operating mobile banking. They are the bank-led and the telecom-led models. The countries having small number of banks use telecom-led mode. In India the bank-led model is used.

Q8. Sources of Risk in Banks

Answer : *April/May-14, Q1(b)*

The various sources or types of risk involved in Banking are as follows,

(i) Interest Rate Risk

(ii) Liquidity Risk

(iii) Credit Risk

(iv) Foreign Exchange Risk.

Q9. What are the significant changes in the Indian Banking Sector?

Answer :

The following are some of the significant changes in the Indian Banking Sector,

1. After the liberalization in 1990s, the role of information technology has increased in Indian Banking sector.
2. In present scenario, banks are mainly emphasizing on rural banking as most of the population is moving towards rural areas. In India, commercial banks realized that profits can be gained by providing services in rural sectors. Therefore, the rural India is developing rapidly in banking sector of the economy.
3. Beside traditional services of borrowing and lending, Banks are offering various secondary and general utility services.
4. From past 10 years, there is rapid growth in use of plastic money. Without these electronic cards it has become difficult to carryout the financial transactions. These cards are fast, flexible and safe for making payments. Similarly, credit cards are easy source of receiving short-term in secured credit.
5. The money market mutual funds were made compulsory by GOI on bank deposits interest rate. Moreover, these funds provide liquidity and higher interest rate on deposits. Commercial banks introduced many deposit products to compete with mutual funds.

Q10. Explain the terms,

(a) National Financial Switch.

(b) Structured Financial Messaging System.

Answer :

(a) National Financial Switch

The National Financial Switch was initiated by the RBI's institute of development and research in banking technology at Hyderabad which facilitates in inter change of common technology infrastructure. NFS mainly deals as a common switch and enable connectivity by acting as an e-commerce payment gateway for ATM, internet etc. Thus, providing authentication regarding route payment details among banks and different parties.

Benefits

Some of the benefits of NFS are as follows,

(i) It provides 24×7×365 convenience i.e., 24 hours of a day all days of a week and 365 days of an year.

(ii) The flow of transaction details are kept secure among buyers, sellers and financial institutions.

(iii) It deals with multi-currency settlements.

(iv) It provides quick and effective processing of transaction.

(v) It provides actual authorization to debit/credit cards.

(vi) It generates flexible and efficient reports.

(b) Structured Financial Messaging System (SFMS)

Structural Financial Messaging System is a software which is enable through modularized web, it is specifically used for financial message communication. It is a flexible system which promotes centralized or distributed deployment, secured messaging and routing depending on store and forward principles.

Advantages

Some of the advantages of Structured Financial Messaging System (SFMS) are as follows,

(i) It makes intra or inter-bank communications fast.

(ii) It gives reliable communication to all practical reasons.

(iii) It is considered as a secured messaging system wherein files are easily transferred from one end to the other end.

Q11. Three Pillars of Basel II

Answer : *(Model Paper-II, Q5 | May/June-17, Q1(j))*

In earlier days, the performance of banks was not adequate and hence lead to failures of many banks. This further instilled the fear that the whole economic system would collapse.

Therefore, to safeguard against the failure of banks, basel has formed the third pillar which has implemented a minimum Capital Adequacy Ratio (CAR) for banks to distribute the funds in a specified ratio which is justifiable in global economy. But Basel I was inadequate due to immense changes in banking industry. So, Basel II, a new capital adequacy framework has been formed. Basel II is much simpler and effective than Basel I.

Therefore, to enhance the strength and reliability in financial system, Basel II has developed three pillars, namely,

1. Pillar I - Minimum capital requirements
2. Pillar II - Supervisory review process
3. Pillar III - Market discipline.

Q12. Bancassurance

Answer : *(Model Paper-III, Q3 | May/June-17, Q1(f) | April/May-14, Q1(h))*

The distribution channels set-up by banks for the purpose of selling insurance products is known as Bancassurance.

The 'bancassurance' is a French term which was first introduced in 1980. Earlier French banks sold more insurance policies. However, the selling of insurance policies by banks became a common practice in most of the European countries and the United States. This practice was adopted even by most of the Asian Banks.

The increased population in India and a wide network of banks with low insurance penetration forced the Indian banks to enter into the insurance business.

Under the Malhotra committee recommendations the government of India Under Section 6(1) (0) of the Banking Regulation Act, 1949 permitted the banks to sell insurance.

INTERNAL ASSESSMENT

I. Multiple Choice

1. ______ is defined as a process of transferring funds electronically from one financial institution to another. [ ]

   (a) EFT
   (b) NEFT
   (c) ECS
   (d) None of the above

2. Credit and debit payment are the two different types of ____. [ ]

   (a) Banking and financial payment
   (b) Retailing payment
   (c) Online e-commerce payment
   (d) None of the above

3. E-cash is one of the _____ payment system. [ ]

   (a) Credit-card based
   (b) Home banking based
   (c) Token-based
   (d) None of the above

4. This two schemes, Privacy Enhanced Mail [PEM] and Pretty Good Privacy [PGP] are the schems of ____ payment system. [ ]

   (a) Plain-credit card
   (b) Encrypted-credit card
   (c) Online third party credit card
   (d) None of the above

5. Fluctuations in the market price of equity results in _____. [ ]

   (a) Foreign exchange risk
   (b) Basis risk
   (c) Market risk
   (d) Equity price risk

6. One among this is the type of liquidity risk _____. [ ]

   (a) Earning risk
   (b) Capital risk
   (c) Strategic risk
   (d) Structural liquidity risk

7. The following reason, increase in cut-throat competition, market expansion and reduction in the costs of products resulted in the generation of _____. [ ]

   (a) Core banking solution
   (b) Retail banking
   (c) Basel committee
   (d) Regulatory capital

8. _____ is the amount of capital which a banker will anticipate to cover future losses which are associated with various risks. [ ]
   (a) Bank capital
   (b) Regulatory capital
   (c) Economic capital
   (d) None of the above

9. _____ means to sell insurance products through bank's established distribution channels. [ ]
   (a) Bank insurance
   (b) Bancassurance
   (c) Insurance
   (d) None of the above

10. _____ is a retail payment system enables to make bulk payments and bulk receipts. [ ]
   (a) Electronic Clearing Services [ECS]
   (b) Electronic payment system
   (c) E-commerce
   (d) None of the above

II. Fill in the Blanks

1. _____ is a substitute of EFT (Electronic Fund Transfer) system.
2. Bank capital consists of _____ and _____.
3. _____ and _____ are related to the financial health of the banks.
4. BCBS stands for _____.
5. Another form of electronic payment system is _____.
6. _____ is a form of digital cash that provides a high level of security.
7. Replacement of currency notes into plastic cards is termed as _____.
8. The credit card is _____ and debit card is the _____ card.
9. 'Cross-selling of products' is one of the useful strategy for the success of _____.
10. _____ arises due to changes in the interest-rate options.

KEY

I. Multiple Choice

1. (a) 2. (b) 3. (c) 4. (b) 5. (d)

6. (d) 7. (a) 8. (c) 9. (b) 10. (a)

II. Fill in the Blanks

1. NEFT [National Electronic Fund Transfer]
2. Assets and liabilities
3. Economic capital and regulatory capital
4. Basel committee on banking supervision
5. E-cheques
6. E-cash
7. Plastic money
8. 'Pay later', 'pay now'
9. Retail banking
10. Optimality risk.

III. Very Short Questions and Answers

Q1. What is e-Cash?

Answer :

Electronic cash is a form of electronic payment system which provide high level of security and reduces the overhead of paper cash.

Q2. Write a note on Bank Capital.

Answer :

Bank capital reflects the net worth of a bank. It consists of both assets and liabilities. Assets of a bank include cash, securities, interest generated from loans, letter of credit, interbank loans. Liabilities include loan loss reserves and debt.

Q3. What do you mean by SWIFT?

Answer :

SWIFT stands for Society for Worldwide Interbank Financial Telecommunications, which is a cooperative society registered in May 1973 in brussels, Belgium. It is a society of international banks which manages computerized telecommunications systems.

Q4. What is RTGS?

Answer :

RTGS means Real Time Gross settlement. RTGS system is a quickest funds transfer process where money is transferred on a "real time" and on "gross" basis from one bank to another.

Q5. Write a note on Clearing House.

Answer :

Clearing house is an organization of banks which promotes payments made by means of cheque among various branches of bank within the place or city. For exchanging the cheque drawn on one another and for claiming funds clearing house becomes a central meeting place for bankers and these type of functions are called clearing operations.

UNIT

4 Introduction to Insurance

LEARNING OBJECTIVES

After studying this unit, one would be able to understand,

- The Concept, Nature, Role and Importance of Insurance.
- History and Development of Insurance.
- Risk Management and the Role of Insurance.
- Features of Insurable Risk.
- Principles of Insurance.
- The Concept and Legal Aspects of Insurance Contract.
- Functions and Types of Insurers.
- The Concept of Reinsurance and its Advantages.
- The Concept, Objectives, Duties and Role of IRDA.

INTRODUCTION

Risk is involved in every activity whether it is personal, professional or business. Risk management is the process of analyzing, evaluating, monitoring and controlling the risk and financial resources in order to reduce the adverse effect of loss in the business.

Insurance is one of the risk management techniques that can mitigate the risks associated with the daily activities of human beings through sharing of losses. Insurance is a means through which the risk can be transferred to other members. It provides security to human beings against these the risks and also compensate the financial loss occur due to any damages by others or an accident.

An insurance contract is nothing but an agreement between insured and insurance company (i.e., insurer) and has to comply with the provisions of the Indian contract Act, 1872. The main purpose of creating insurance contract is to transfer a part of risk of loss from insured to insurer. Insurance programs are assisted by both private and public insurers. The insurers who absorb whole risk of insured can also avail insurance benefits by reinsurance.

Insurance Regulatory and Development Authority (IRDA) monitors and controls the whole insurance activities and reinsurance programs.

4.1 INSURANCE – DEFINITION AND NATURE OF INSURANCE

Q1. Define Insurance. Explain the nature and characteristics of insurance.

Answer : *Model Paper-I, Q9(b)*

Insurance

According to the commission on insurance terminology of the ARIA, insurance is defined as, "The pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insureds for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk".

Nature of Insurance

The nature of the insurance contract is summarized as follows,

1. **Risk Sharing**

Insurance is a contract through which an individual or his family shares their financial losses on the occurrence of any particular incident/accident. Example: Event of death in case of life insurance contract or event of fire in case of fire insurance contract.

2. **Co-operative Device**

Insurance is considered as the co-operative device because in every insurance plan co-operation of large number of individuals is present for sharing financial losses against the event which is insured.

3. **Premium Amount**

The amount which is paid by the insured in the contract of insurance is called as premium. The amount of insurance premium paid usually depends upon the degree of risk involved in a specific event.

4. **Division of Risk and Premium**

The degree of risk involved and the amount of premium which has to be paid for the insurance would be reduced to a great extent when the number of individual/contributors are more in number.

Insurance is Not Charity

Insurance is the protection provided to the insured or to his property in consideration of the premium amount. On the other hand, charity is provided without any security, protection and consideration. Thus, insurance is different from charity.

Characteristics of Insurance

Based on the above definition the basic characteristics of insurance can be enumerated as follows.

1. **Pooling of Losses**

Pooling is the fundamental characteristic of insurance. It refers to the spread of loss of one to many, in order to substitute actual loss with average loss. Thus, pooling technique involves sharing of losses and also prediction of future losses.

Secondly, when an insurer pools the experiences of a large number of explosive units, he is capable of envisaging future losses more precisely. This minimizes the risk. Risk minimization is another feature one comes across in insurance, which is based on the law of large numbers. Which states that,

The law of large numbers states that "Greater the number of exposers the more closely will be the actual results approach the probable results that are expected from an infinite number of exposures".

2. **Fortuitous Losses**

Another important characteristic of insurance is that it pays fortuitous/accidental losses. Insurance covers unforeseen and unexpected or accidental losses, which have been grouped under fortuitous losses and are unintentional and occur due to a chance factor.

3. **Transfer of Risk**

Insurance essentially involves transfer of risk from insured to the insurer. Since an insurer is in a better financial position than individual insureds, he indemnifies the insured for losses due to premature death, poor health, disability, theft or loss of property etc.

4. **Indemnification**

Indemnification means restoring the insured to his financial position prior to suffering a loss. For example, if a business man insures against loses due to fire suffering, the insurer pays his losses covered under the fire insurance policy. Similarly, a person losing wages due to occupational disability gets paid under the disability income insurance policy.

Q2. List out the advantages and disadvantages of insurance.

Answer :

Advantages of Insurance

A firm can gain more by using insurance as a risk management technique. The advantages of managing risk using insurance include,

(i) The losses incurred for a firm can be indemnified or recovered through insurance without affecting the profitability of the firm.

(ii) Insurance reduces the uncertainty of the firm's plans which results in enhancing firm's productivity and performance.

(iii) Insurance offers number of risk management services and loss control services such as exposure analysis, claim adjustment to mitigate the risk and losses.

(iv) Insurance premiums paid by the insured's firm are excluded from the income tax which is a benefit to firms.

Disadvantages of Insurance

The disadvantages of insurance are as follows,

(i) The financial compensation is not provided to the insured on time due to lengthy legal formalities.

(ii) It does not give the facilities which are provided by banks, though it encourages savings.

(iii) It purposely compensates less to the sufferer to maximize its profits instead of maximizing the well-being of the insured.

(iv) Beneficiaries may sometimes make wrong use of the insurance policy. They may commit crimes to get the insured amount. Thus, corrupting the society.

(v) The insurance companies do not provide compensation for all the losses in a business.

4.2 ROLE AND IMPORTANCE OF INSURANCE

Q3. Explain the role of insurances in economic development.

Answer :

From the business economics perspective, insurance is nothing but an economic device which helps in minimizing the risk by integrating a sufficient number of exposure units to ensure that their individual losses are predicted collectively.

Insurance plays an important role in the economic activities. In general, people want to avoid the irregular and probabilistic risks related to their assets such as wealth, wisdom and health. To avoid such risks, they make use of many risk management tools such as, "purchasing insurance". As there is a growth in general wealth, the growth in the value of assets has also increased. This results in "Catastrophic risk".

With the change in time, people are becoming more concerned about their assets. Thus, the importance of insurance is increasing subsequently.

Insurance is a secondary branch of economic activity that deals with different economic problems that would arise if insurance does not exist. Insurance is significant in international and interpersonal trade, credit and payment transactions, production and consumption, conservation of existing wealth and the creation of new wealth. Nevertheless, insurance serves differently across different industrialized countries as per their regulatory regimes.

The recent trends are bringing several changes in the service sector. As insurance industry is also the part of service sector, it is also influenced by the latest trends. In the present risky environment, insurance acts as a means for risk management. It is essential for a well performing insurance company to play a vital role in economic development.

In order to determine the economic importance of the insurance company, five main alternative ways can be adopted. They are,

1. The importance of insurance can be measured by the number of insurance companies in a particular country. There exists a positive correlation between number of insurance companies and the market size.

2. The second indication of its importance is the number of employees working in the insurance industry. The increased workforce in industries of a country results in better performance of insurance sector.

3. "Premium income" is an important indicator for comparing the importance of insurance services in different countries. It allows you to assess the importance of insurance.

4. "Contribution of insurance industry to GDP" is a preferable indicator of importance of insurance from economic perspective.

5. An appropriate measure to find the industry's contribution towards economic development is the "sum of consumer and product surplus".

Q4. Explain the role of insurance in social security.

Answer :

The role of insurance in social security is divided into,

I. Social security to individuals and

II. Social security to Business.

I. Social Security to Individuals

The role of insurance in social security of individuals is as follows,

(a) Insurance Provides Stressless Life

The security is major inspirational component, which motivates to be productive. In case of inadequacy it may generate stress which may exhibit itself in an annoying response at work place. The existence of activities like premature death, accidents and fire windstorm, which are unknown in nature may dissatisfy the human minds. In such cases, the sense of uncertainty can be terminated by measure of insurance.

(b) Insurance Ensures Secured Life

Insurance ensure the secured life against the loss on a certain occurrence. Life insurance provides security in case of premature death and old age sufferings. In similar manner insurance is provided to certain unpredictable events like loss at fire, damage, destruction or disappearance of buildings, goods, place and machinery.

(c) Mortgaged Property Can be Safeguarded by Insurance

In some cases, at the death of the owner, the property loses its ownership and the family is underprivileged for use of the property. The insurance is provided to the dependents to make payment of unpaid loans at the premature death of the property owner.

(d) Insurance Facilitates to get Rid of Being Dependent

In case of premature death of father or the husband, the family suffer a lot where economic independence is decreased or totally lost. Thus, insurance provides assistance by adequate amount to dependents in the family, destructed property and goods at the time of suffering.

(e) Life Insurance as a Source of Profitable Investment

The policyholder can be benefited with frequent income for his investment in life insurance from life insurer. Various types of investment are provided to the individuals who are unable to handle their funds by the life insurance policies. For instance Endowment policies, multipurpose policies, deferred annuities etc, which are better source for profitable returns.

(f) Life Insurance Motivates for Saving

Life insurance is the best mode of protection and investment. The life insurance policies combines saving with insurance. Certain benefits includes compulsion of periodic payment of premium leads to planned savings, the policy holder receives the money irrespective of premium been paid etc. In case of property insurance, only protection is given to the insured.

(g) Satisfying the Needs of a Person by Life Insurance

Life insurance also fulfils certain needs of a person which are divided in to family needs, old age needs, re-adjustment needs, special and clean-up needs.

II. Social security to Business

Insurance also helps the Business society. The uses of insurance in business are as follows,

(a) Reduces Uncertainties in Business

To meet the needs of situations of uncertainties in the world of business, commerce and industry, the insurance policy is taken.

(b) Helps in Providing Compensation to Key Man

The key man is a specific employee, who is the most valuable asset for the business. In his absence or death, the amount of loss may be reduced profit in case capital, energy, goodwill etc. Adequate purchase of life-policies like the term insurance policy or convertible term insurance policy are better for the payment to the dependents and expense of employer.

(c) Improved Efficiency of Business with Insurance

The efficiency of business can be improved by guaranteed payment of amount with the insurance policies at the death of an individual or destruction or damages of property which removes the unknown losses and encourages the businessmen to work hard and maximization of profit.

(d) Extension of Business

Business like partnership business, if any partner may get dissolved or discontinued, then the whole business will suffer. In such cases, the insurance policy is the best way which provides sufficient funds not only to the dependents but the interest of each partner is insured.

(e) Increase in the Value of Credit

The business can pledge the policy as collateral for securing the loans. In case of death, the cash value can be used for resolving the loan along with the interest. If the borrower is resistant to repay the loan then the lender can surrender the policy and get back the loan and interest. Therefore, the insurance properties are the best collateral.

Q5. Explain the need and importance of insurance.

Answer : *May/June-12, Q5(a)*

Need of Insurance

Everyone needs insurance for the following purposes,

1. To protect oneself from the financial losses.
2. To protect family from loss of income after one's death.
3. To deal with contingent liabilities.
4. To safeguard the business from loss of income and business interruption.
5. To make debt repayment after one's death.
6. To manage oneself at the time of disability.
7. To safeguard oneself from the lawsuits.
8. To look after oneself against unpredictable health expenses.
9. To protect one's car from various losses or theft due to accidents.
10. To safeguard one's home from flood, theft and fire.

Importance of Insurance

Life of human beings is full of risks and uncertainties. Insurance provides security to human beings against these risks and also compensate the financial loss due to any damages by others or an accident. It has been observed that the importance of risk management in the business increases with an increase in complex economic system and competition in industry. Risk management can properly manage the risk using any one of the risk management techniques such as retention, noninsurance transfer of risk and insurance. The increase in the use of insurance to manage risk is because of the increase in hurdles in business functions through the risk. It is necessary to mitigate the risks associated with the business activities to minimize the financial loss and other expenses that may affect the profitability of the firm. Risk management through insurance can facilitate the smooth performance of business operations without pure risk. This will thereby lead to increase in firm's profits.

If a manager avoids pure risks using the insurance, the business is then required to face only normal risk which is very common with every investment. A firm can survive in long run only if it is capable of managing effectively and able to sustain the risks associated with the risk management techniques.

Other than the firms, individuals also require risk management using insurance in order to safeguard their life and the life of their dependents.

4.3 HISTORY AND DEVELOPMENT OF INSURANCE

Q6. Discuss the evolution of insurance in detail.

Answer :

The evolution of insurance can be classified into six phases,

1. Pre-greek period
2. Ancient greece period
3. Roman empire
4. Dark ages
5. Revival of international commerce
6. Insurance in 1600.

1. Pre-Greek Period

In pre-Greek period, Babylon (500 B.C) was considered as the origin of western civilization associating India, Persia and China to Phoenicia, Egypt and Aromania. Babylonia imported gold, silver, copper, valuable stones and woods etc. The trade routes frequently experienced fire storms, bandits and pirates and deaths. The Babylon merchants levied additional amount for risk including interest on capital.

The code of Hammurabi validated the concepts of civic responsibility, bottomry and respondentia to enhance the conditions of trade. The maritime agreements known as bottomry and respondentia were made on vessels or on cargoes. Following were the basic features of this agreement,

(i) A loan on the vessel, cargo or shipment.

(ii) An interest rate on loan.

(iii) An additional risk payment for the probability of loss of the venture and for the cancellation of debt.

According to the provisions of bottomry bond, if the borrower lost the security with no intention of his own, then he is freed of the allegation. Bottomry loan is the same as new credit life disability insurance.

2. Ancient Greece Period

The Greek era of modern history signified the development of early times i.e.,

(i) Well-establishment of bottomry contract.

(ii) Evolution of the concept of averages.

In Athens, the first insurance exchange is said to be established and consequently at Lloyd's of London. The risk premiums were charged basic on different factors and were set in the manner the insurance rates are set today.

3. Roman Empire

The Romans were communicated about the Greek traditions in insurance. Romans also began to follow the bottomry and other related contracts. Although the Romans had an insurance exchange but the key contribution they made to insurance was organized by burial society which is a fundamental form of health and life insurance. These societies were known as Eranoi and Thiasoi in Greece but the Romans came up with more improved burial and benevolent services through their "collegia". The "collegia" symbolizes the contribution of Romans to the history of insurance.

4. Dark Ages

In the fifth century A.D, the Roman empire had a great downfall. This lead to negligible international commerce and the formation of small self sufficient communities. The guilds of middle ages were formed from the "collegia" of Rome. The guilds further intended their operations to involve artisans, craftsmen and professional persons. This resulted in the development of economic, political and religious organizations. Trade guilds provided the mutual protection for loss occurring due to fire damage to livestock or any other accident. By the eighth century, insurance became a contributor of a business society.

5. Revival of International Commerce

In Venice, Geneva, Florence, Naples, Tarentum and Bari, bottomry agreements were widely used before 1000 A.D. Marine insurance had also made advancements from twelth century to fourteenth century. Europe's pattern of trade was well-established by 1400 with respect to low state of transportation technology. In the renaissance of commerce and insurance, bottomry bonds were greatly utilized for all major routes in shipping.

6. Insurance in 1600

In England, the insurance business proved to be highly prospering at the end of Elizabeth reign. Many centres were developed for the contracts and sufficient markets. Initially, sole proprietors administered insurance on an individual basis but later it became mandatory for insured to acquire joint participation of underwriters to provide full coverage.

Consequently, the insurance market experienced fast-pace growth with greater competition across the world.

Q7. Explain the historical background of insurance in India.

Answer :

The Insurance Sector in India started in 1818 with the commencement of Oriental Life Insurance Company. But later in 1834, the company had a breakdown and it stopped operating. In 1829, another company called the Madras Equitable Life Insurance Society began its operations in Madras. In the year 1870, the foreign insurance companies like Royal Insurance, Liverpool and London Globe Insurance started its functioning in India under the British Insurance Act, 1870. This resulted in great competition between the foreign insurance companies and Indian insurance companies like Oriental Assurance Company and the Bombay Mutual Life Insurance Society.

In India, the first general insurance company was the Triton Insurance Company Limited which was setup by the British in Calcutta in the year 1850. The insurance companies at first insured only the European citizens in India and not the Indians. Later, when they began to make insurance available to Indians too, they charged 20 percent higher premium for them because of the riskier lives of Indians. The Bombay Mutual Life Insurance Society levied equal premium to its customers irrespective of their nationality and was the first company to do so. In 1907, the Indian Mercantile Insurance Company Limited was established in Bombay. This company was the initiator of general insurance in India. The government aimed to accelerate the growth of insurance business in the country. Hence, in 1912, the Indian Assurance Companies Act was enacted. Another Act known as the Insurance Act, 1938 was enacted in order to regulate and safeguard the activities of insurance companies.

Many insurance companies faced a downfall and resulted in termination. In 1956, there were only 154 Indian Insurance companies, 16 non-Indian and 75 provident societies. The government aimed at making even the towns and villages aware of insurance companies. The 245 Indian and foreign insurers and provident societies were recognized by the government under the Life Insurance Corporation of India Act, 1956 of the Parliament. The main purposes of establishing Life Insurance Corporation (LIC) were,

1. Firstly, to levy premiums as validated and coordinate business with higher economy.
2. The second purpose is to constantly safeguard the capital and invest funds to acquire more returns for the policyholders.
3. Finally to make insurance prevailing by delivering quick and productive services to policyholders.

In the year 1957, the General Insurance Council was established which developed certain foundations to regulate the insurance business. In order to lay low solvency margins, the Insurance Act was modified in 1968. The Tariff Advisory Committee was also established.

In 1972, the government of India enacted the General Insurance Business Act and acquired 55 insurers controlling general insurance business. It also purchased the shares of 55 Indian insurance companies. Later, these companies were integrated into four companies known as, the National Insurance Company Limited, the New Indian Assurance Company Limited, the Oriental Insurance Company Limited and the United India Insurance Company Limited.

The General Insurance Business Act, 1972 included the general insurance corporation of India in the section 9(1) of the Act. The General Insurance Corporation of India was designed with the intention of supervising, managing and conducting the business of general insurance.

Q8. Discuss briefly the development of insurance in India.

Answer :

The term insurance was first conceptualized in the 14th century. It was used mainly for protection of sea travellers for conducting foreign trade. The concept of insurance has undergone a lot of changes since then. Due to the break up of traditional extended family system, insurance business got the opportunity to grow more.

The insurance business grew over a period of time with the advancement made in industry, trade and commerce. Currently, India stands in fifth position in terms of premium collection. The ratio of insurance premium to GDP is low despite of a two digit growth. Presently, out of more than one billion population, only 70 millions people are insured in India. The non-life insurance business needs to play an important role in protecting the properties of people. In 2000, the gross domestic premium income of general insurance business registered an increase of ₹ 9522 crores as compare to ₹ 184 crore in 1973.

Until 1956, 229 Indian insurance companies, provident insurance societies and 16 non-life Indian companies were conducting life insurance business in India. However, on 19th January, 1956, the government of India undertook the control and ownership of life insurance business. Since 1986, Life Insurance Corporation of India (LIC) was established with a bill passed in parliament. It was started functioning since 1st September 1956, Life Insurance business's growth is analyzed under new business which consists of group insurance business, new business individual insurances and not considering annuities, growth in assured sum and number of policies, average amount per policy, new rural business, business in force, number of offices, asset's productivity and process of new plans of insurance.

The insurance industry's performance is reflected by the overall performance of the economy. The underwritten of life insurance premium in India and abroad registered an increase of 24.31 in 2004-05 as compared to previous year. On other hand, non-life insurers registered a growth of 12.09%. The joint growth from both companies were 12.09% after adjusting for inflation. First year premium, single premium and renewal premium contributed 19.16%, 12.47% and 68.36% respectively.

In order to meet the need of insurance products for rural and urban poor, IRDA finalized and issued guidelines on micro-insurance. The regulations on micro-insurance gives a platform and rules to get insurance for selected segment.

As many insurance companies giving importance to unit linked business and to protect the interest of policy holders, the authority is finalizing the guidelines for this section.

The authority has acknowledged the importance for the growth of insurance in India. Due to the lack of regulations in health sector and prevailing malpractices in the system, the authority established a separate health insurance unit in IRDA on recommendations of health insurance working group.

In order to ensure collection and maintaining of quality data by the insurance companies, IRDA outlined a road map, which focussed on the steps to be taken by insurance companies in field of underwriting, rating of risks, policy terms and conditions, corporate governance and tariff advisory committee's role.

4.4 RISK MANAGEMENT AND THE ROLE OF INSURANCE

Q9. Define risk. What are the different types of risk?

Answer :

Risk

Risk is involved in every activity whether it is of personal, professional or business. Every individual, while doing any activity expects some returns. But, it is obvious that the actual returns may never be the same as that of the expected returns. There always exists a difference between the expected and the actual returns. This difference is termed as 'Risk'.

Types of Risk

Risk are classified as per their origin and consequences. The following are the major categories of risks,

1. Pure risks
2. Speculative risks
3. Fundamental risks
4. Particular risks.

Let us discuss each of them in detail.

1. Pure Risk

In pure risk, there is either the chance of only loss or no loss. The result may be unfavourable and neutral. It is quite easy to apply the law of large numbers on pure risks. This law is considered important as it allows the insurer to predict future loss experience. If a loss occurs in pure risks, then it is unfavourable for the society.

Pure risks are classified into the following types they are,

(i) Personal risks

(ii) Property risks

(iii) Liability risks.

(i) Personal Risks

The risk that influences an individual directly is called as personal risk. Personal risks may include decrease in the value of financial assets, probability of deduction in earned income and additional expenses.

(ii) Property Risks

When the property is damaged or lost due to any reason then the owner of the property is vulnerable to property risks. These damages or destructions can be caused due to lightning, tornadoes, fire, windstorms or other reasons.

(iii) Liability Risks

Under the legal system, a person can be held legally responsible if he causes any damage to the property or physical harm to someone. The court of law may impose a fine with respect to damages made to the injured person or property. In liability risk, the amount of loss does not have any maximum upper limit. The court may place lien on the financial assets and income of the person to comply with the legal judgement. The importance of liability risk can be understood from the fact that the cost of legal defence is very high if you do not have liability insurance.

2. Speculative Risk

Speculative risk is a circumstance where either profit or loss can occur. The future losses are difficult to estimate in speculative risk and hence, it is not easy to apply the law of large numbers here. A speculative risk is considered beneficial to the society even if a loss occurs.

3. Fundamental Risk

The risk which impacts many persons or a group or the whole economy is known as a fundamental risk. Some of the fundamental risks are war, immediate inflation and natural disasters (Like earthquakes, floods, tornadoes and hurricanes). These activities have an impact on large number of people and their properties. Now-a-days, terrorism is also considered a fundamental risk as it is resulting in the loss of human lives. Government cooperation is required for insuring a fundamental risk.

4. Particular Risk

The risk which impacts only certain individuals and not the whole group or community is known as particular risk. It does not affect the whole community, rather it only affects the individuals related to such losses.

The following are the other types of common risks involved in a business. They are,

(i) Credit Risk/Default Risk

In a contract, when any one party fails to fulfill his financial obligations then it is termed as credit risk. As this risk arises from parties, it can also be termed as counterpart risk. In a simple terms, the risk of non-payment is termed as a credit risk.

(ii) Price Risk

When a firm faces the risk due to fluctuations in prices then it is termed as price risk. Prices tends to change because of the changes in demand and supply. A buyer desires to purchase goods for a low price, whereas a seller intends to sell them at a high price. This creates a change in prices, which is called as price risk.

(iii) Market Risk

A firm faces market risk when value fluctuates due to market factors. Market factors include market interest rates, equity prices, foreign exchange rates and commodity prices. Usually, market risk is called as systematic risk, non-diversified risk or beta risk.

Q10. What do you understand by Risk Management? What are its objectives? What are the different types of risk managing firms?

Answer :

Risk Management

Risk management is the process of analyzing, evaluating, monitoring and controlling the risk and financial resources in order to reduce the adverse effects of loss in the business.

Objectives of Risk Management

The objectives of risk management are classified as follows,

1. Pre Loss Objectives

Before the occurrence of loss, the objectives of risk management are,

(a) It aims at reducing fear and anxiety in the minds of exposed units and improving the value without constraints on operating activities.

(b) To get prepared well for the substantial losses in an economical way. For this preparation, an analysis is carried out on cost safety programs, insurance premium paid and the costs involved in handling losses.

(c) To check whether all obligations are met or not.

2. Post Loss Objectives

After the occurrence of loss, the objectives of risk management are as follows,

(a) The survival of a firm is an important objective of the risk management. In case of any loss, a firm should be in a position to resume the operations with some reasonable time period to ensure its survival in the market.

(b) To continue the operations even if the loss occurs.

(c) To maintain the stability in the earning of the firms. To achieve this objective, the firm may have to undergo additional expenses. It may have to shift its operations from one location to another location.

(d) The firm should show a continuous growth once it becomes stable. It can design new products and can enter into new markets.

(e) The risk management should minimize the effects of loss on other persons and society.

Types of Risk Managing Firms

Generally, the business firms are classified based on risk perception. The different types of risk managing firms are as follows,

(i) Risk Controllers

These are the firms which use risk management only for the purpose of internal control.

(ii) Efficient Enhancers

These firms use tools of risk control to run their business more effectively. They emphasize more on the strategic issues of risk management instead of implementation issues. These type of firms make use of customized software solutions.

(iii) Risk Transformers

These firms take risk management positively and consider it as a business opportunity rather than a problem. They emphasize more on design of new financial products for the management of risk.

Q11. How do you manage the risks? Discuss the various steps involved in risk management process.

Answer :

Management of Risk

Management of risk involves the identification, assessment and control of various risks that are associated with the earnings and capital of an organization. The main sources of these risks include legal liabilities, financial uncertainty, strategic management errors, natural disasters and accidents. Digital companies face IT security threats and data related risks. In order to reduce the risks, the companies use a common risk management process.

Risk Management Process

The several steps of risk management process are as follows,

1. Identify all Significant Risks

Identifying the common and the crucial risks is the initial step in risk management process. There are various sources to identify the risk. They are,

(i) Questionnaires are distributed to know the opinions of risk managers and based on their feedbacks risk can be evaluated.

(ii) Companies need to investigate physically with regard to their operations and plans.

(iii) The firm's financial statements are analyzed and evaluated to determine various risks faced by its stakeholders like key customers, key suppliers etc., and depending on this, decisions are made to preserve the assets and prevent losses.

(iv) By evaluating the flow charts, the flow of production and the units of products that has to be delivered can be ascertained, which shows whether the stock is in excess or scarce. By analyzing the level of stock, a huge amount of financial losses can be assessed.

(v) Based on the historical data and past experience, risk can also be ascertained.

Following are the various types of risks,

(a) Amortisation of company's goodwill.

(b) Risks to human resources includes retirement or unemployment and death or disability of key employees.

(c) Crime loss like robberies, theft of intellectual property, dishonesty and fraud.

(d) Property loss such as loss of furniture, building, computers and accounts receivable.

(e) Business income risks like extra expenses and unexpected loss of business income.

(f) Foreign risk such as foreign currency risks, political risks and acts of terrorism.

2. Evaluating the Risk Exposure

In this step, the frequency and the severity of losses are predicted. Loss frequency means most predictable losses that are likely to occur and loss severity refers to the quantity of losses that are bound to occur.

After predicting the frequency and the severity of losses by a thorough analysis, the most appropriate techniques are applied to reduce such risk. If the losses tend to occur frequently and can be expected, then those losses are treated as normal operating expenses and hence deducted from the firm's income. The losses which occur rarely and cannot be anticipated are simply faced as and when they occur.

3. Develop and Select the Appropriate Methods

Based on the circumstances, an appropriate method or a combination of methods are applied.

4. Implement and Monitor the Performance of Risk Management Program

The risk management program is implemented and the performance is monitored by the following procedure,

(a) Risk Management Policy Statement

This statement consists of objectives and policies involved in reducing the risk. It also gives a clear idea to the top management with regard to the performance of the risk managers.

Apart from this, risk management can be developed manually and implemented in this program. This technique especially helps in training the new employees and stating them all the objectives and responsibilities which contributes towards enhancement of the effectiveness of risk management.

(b) Cooperation with other Departments

Cooperation with all other departments such as, accounting, finance, marketing, production and human resources, enables an organization to identify the risk and implement the effective methods to reduce the risk.

(c) Periodic Review and Evaluation

It is very essential to check and analyze the risk management program periodically. Especially, loss-prevention programs, safety programs and risk management costs must be focused as it constitutes the major amount of risk.

Q12. Explain the solutions offered by the insurer to manage certain risk.

Answer :

The following are the solutions offered by the insurer to manage certain risks. The risks are,

1. Risk of premature death
2. Risk of disability
3. Risk at old age
4. Risk of liability and physical damages.

1. Risk of Premature Death

The death of the family head with unsatisfied financial responsibilities is called as premature death. When the dead person has other members relying upon him or dies with unfulfilled financial responsibilities, then premature death can create financial difficulties. Hence, the death of a child with age six cannot be considered as premature death in economic terms. The members of the family may face financial uncertainty if they do not have reliable sources for adequate income or have limited financial assets to compensate the loss.

In this situation, the life insurance will offer a cash asset known as 'Sum assured or annuities' which is payable to the family to meet the future needs. This payment is made in return to the amount paid by the decreased in small amounts as premium.

There are many kinds of life insurance plans. The beneficiaries can avail different benefits upon the death of insured as per the conditions of the selected plan. Under term assurance, temporary coverage is available for short period at low cost. Total amount is payable on unexpected death of the insured during the term. The other policies that provide death converge include whole life policy, the endowment policy, the unit linked plan etc.

Life insurance provides security in many ways. Generally, the partnership is dissolved when the partner dies and the investment made by the partner is paid back. This risk can be managed by the partnership insurance provided by life insurance. In the same, way a policy of key man insurance helps in managing the risk of loss that may occur due to the unfortunate death of the employee.

2. Risk of Disability

When a person becomes disable either due to the injury or sickness, he/she will not be in a position to earn the income. In this case, if the insured purchased disability insurance as a policy or as a supplement to the existing one, then the insurance firm will provide guaranteed income to manage the recovery cost and various other expenses.

3. Risk at Old Age

Presently, a significant role is given to the retirement planning for managing the personal risk. Individuals at their working years, wish to have their old age as financially independent, safe and healthy life. A policy called media claim can take care of the old aged tensions regarding health and income. It provides annuities or personal pension plans to release the individual from their worries for uninterrupted income.

4. Risk of Liability and Physical Damages

Under the legal system, a person can be held legally responsible if he causes any damage to the property or physical harm to someone. The court of law may impose a fine with respect to damages made to the injured person or property. In liability risk, the amount of loss does not have any maximum upper limit. The court may place lien on the financial assets and income of the person to comply with the legal judgement. The importance of liability risk can be understood from the fact that the cost of legal defence is very high if you do not have liability insurance.

To overcome the risk of liability and physical damages, the non-life insurance companies are offering liability insurance coverages.

Lightening, fire, earthquake, tornado, flood, theft, accident and burglary are the major types of risks which are creating damage to the property. It is possible to manage these risks by transferring it to the insurance companies under different plans such as auto insurance, agricultural and cattle insurance etc.

Q13. Discuss in detail the basic principles of insurance as a risk transfer mechanism.

Answer :

The following are the basic principles of insurance which act as a base for risk transfer mechanism,

1. Sharing the Losses

If large number of people experience same risks, then they are grouped together and the risk suffered by few people will be spread over this large group. A fund is created for the individuals who face the similar risk, they are required to contribute a small sum of money. This amount is used to compensate the loss faced by few individuals. This concept of 'spreading risks' forms the basic economic principles of insurance in association with the theory of probability and law of large numbers.

The probability theory is a technique used for calculating the likelihood of an occurrence. This probability is measured on a scale from 0 to 1 where 0 indicates impossibility and 1 indicates certainty. The law of probability helps in predicting the likelihood of future events. On the basis of the knowledge that occurred in the past under similar situations.

Objective probability is a probability for which there exist evidences from the part and general experience in order to support the decision. The probability of future event is measured on the basis of the past experience. However, historical information is not available always depend on his own estimation of a situation and probability of different possible outcomes. Thus, this type of estimate is known as 'subjective probability'.

2. Law of Large Numbers

The insurer finds the law of large numbers very useful. The law describes that if the exposure units increases then there is more possibility that the actual experience will approach the expected experience. If the sample is large, then there are more chances that the frequency of occurrence coincide with the average frequency which can be made through theoretical calculation. In insurance the law of large numbers has dual applications. It is essential for the insurer to have large volume of historical data so that accurate prediction can done easily. A large number of contracts should be entered once the estimation is done. This is to avoid losses that may occur due to small numbers.

3. Equality of Risk

If any loss occurs to few individuals, then the loss amount is paid from the common fund which is contributed by the individuals or the enterprises in the group. Therefore, such contribution is known as 'premium'. As per 'equity' every individual of the group must contribute a premium that would be in accordance with the risk which an individual contributes towards the fund. The risk is neither uniform in quality nor it is uniform in quantity. Therefore, the method of deciding the required contribution to fulfil the risk carried out based on 'Actuarial' or 'mathematical principles'.

4.5 FEATURES OF INSURABLE RISK

Q14. Describe the features/elements of an insurable risk.

Answer :

Ideally insurers issue insurance policies only for pure risks. But it should be noted that all pure risks aren't insurable. Before privately insuring a pure risk, the following requirements must be fulfilled.

1. Large Number of Exposure Units

A large number of exposure units is the primary requirement of an insurable risk. The exposure units should also be homogeneous. For example, a large number of apartments can be covered against property perils under a property insurance policy. This requirement is essential for an insurer to apply the law of large numbers. If the number of exposure units is large, insurers can predict loss using "law of large numbers". Also, the loss cost can be computed and spread among all the insureds.

2. Loss Must be Determinable and Measurable

For a risk to be insurable, it should be determinable and measurable. It implies that the loss is determinable in terms of cause, place, time and amount. For example, in case of a life insurance, the cause and time of death are determinable. The amount to be paid is also measurable as the face value of life insurance policy.

However, every risk is not determinable or measurable. Consider the subjective terms like disability and sickness in disability income insurance. It is difficult to determine if the insured is disable or sick as applicable in the policy. The period of disability is also not measurable. While a healthy person recovers fast, the same injury might take longer time to cure a weaker employee. Hence it is immeasurable in this case.

3. The Loss must be Accidental

Thirdly, it is important that the loss is accidental. No insurer insures a deliberate loss. The loss should be unintentional and beyond control of the insured. Unless the loss is accidental, the insurer cannot apply the law of large numbers which is based on the random occurrence. Prediction of losses is difficult if the losses are incurred deliberately.

4. Chance of Loss must be Calculable

Another requirement of an insurable risk is that its chance of occurrence is calculable. Insurer needs to have an information on the frequency of losses incurred and the losses expected in future. Insurers must be able to predict future losses, so that they can fix a premium which would cover all claims and expenses and provide some profit yield during the policy period.

5. Premium Should be Economically Viable

The premium must be economically viable. The insured should be able to pay the premium. For a premium to be economically viable, chance of loss should not be high. If the chances of loss are high, the premium would also be high and exceed the value of the policy.

6. Loss Should not be Catastrophic

Another major requirement of an insurable risk is that the loss should not be catastrophic i.e., the loss should not be in large units at a same time. A large number of exposure units should not incur losses simultaneously, or the essence of pooling is lost. Consequently, premiums would have to be increased to unaffordable levels, making insurance is no longer viable. Therefore, insurers avoid catastrophic losses.

However, catastrophic losses arising from floods, earthquakes, fires and other natural disasters could be insured through reinsurance. Reinsurance means transferring a portion of the small insurers risks to a reinsurer who indemnifies insurance companies from catastrophic losses. Another way to avoid catastrophic losses is to spread the coverage over a much larger area.

Private insurers insure the risks fulfilling the above requirements. Thus, while life and health risks and property risks are insured, financial risks, market risks, political risk and like are generally avoided.

4.6 PRINCIPLES OF INSURANCE

Q15. Write a note on principles of insurance.

(Model Paper-I, Q9(a) | May/June-16, Q5(b))

OR

Explain the principles of insurance.

(April/May-15, Q5(a) | May/June-12, Q5(b))

OR

Explain the basic principles of insurance.

Answer : *April/May-14, Q5(a)*

The various principles of Insurance are as follows,

1. Principle of Insurable Interest

Principle of insurable interest is one of the legal principle of insurance contracts that supports the principle of indemnity. An insured should satisfy the requirement of insurable interest while collecting the amount by proving the loss due to misused peril. For example: A person has insurable interest in his car because he may lose financially if the car is stolen or damaged.

2. Principle of Indemnity

The principle of indemnity states that the insurer should not pay more than the actual amount of loss. In other words, it states that the insured should not make profits from the loss incurred by him. Several property and casualty insurance contracts are the contracts of indemnity.

3. Principle of Subrogation

Principle of subrogation is one of the legal principles of insurance contract and supports the principle of indemnity. This principle provides the benefit to insured to claim the insurer for any loss incurred due to the negligence of third party. The insurer then can proceed against the third party to recover the loss paid to the insured.

4. Principle of Contribution

Contribution refers to the insurer's right who has paid compensation for the loss under a policy, to recover a specific amount from the other insurers who are supposed to cover the loss. The principle of contribution supports the principle of indemnity.

5. Principle of Utmost Good Faith

Insurance contracts involve information asymmetries between parties. Generally, the insured has a better idea about the risk to be insured than the insurer. In order to balance this, the law specifies that both the parties should disclose any information important to the contract. The principle of utmost good faith specifies that both the parties should openely and honestly disclose the information without concealing any material facts that may affect the judgement of the other party.

6. Principle of Proximate Cause

Proximate cause is a legal term that describes how exactly the loss occurred. One should establish the cause of a loss as only risks particularly against can be compensated. The dominant and effective cause will be taken into consideration if there exists more than one cause for a loss. Thus, remote cause will not be considered here.

4.7 LEGAL ASPECTS OF INSURANCE CONTRACT

Q16. Define insurance contract. What are its distinguishing features?

Answer :

Insurance Contract

An Insurance Contract is nothing but an agreement between insured and insurance company (ie insurer) and has to comply with the provisions of the Indian Contract Act, 1872. The main purpose of creating insurance contract is to transfer a part of the risk of loss from insured to the insurer.

Features of Insurance Contract

The following are the distinguishing features of insurance contracts,

(i) Aleatory contract

(ii) Conditional contract

(iii) Contract of adhesion

(iv) Unilateral contract.

Let us discuss each in detail below,

1. Aleatory Contract

Insurance is considered as an aleatory contract. Aleatory contract means the contract in which there exists differences in the exchange values of the parties involved in the contract. Aleatory occur because of the risks associated with the results of contracts. It occur if the insured has repaid the loss amount by insurer more than the premium paid for loss incurred within the maturity period of the policy. Otherwise, if the loss occur after the period of policy, insured will be paid less amount by insurer than the premium paid by insured person.

The aleatory does not occur as the underwriters of insurance policy structure the appropriate premium by considering all the claims and risks involved.

2. Conditional Contract

Insurance is considered as a conditional contract. Insurer should frame the terms and conditions of the contract and the insured person is required to accept those conditions before purchasing the policy. Insurer will be held only if the insured person is agreed upon the conditions. The important conditions include premium structure, term of policy, documents for the proof of loss, notices to insurer about loss etc.

3. Contract of Adhesion

Insurance is considered as a contract of adhesion. Under this characteristic, the conditions that are prepared by the insurer should be accepted by the insured while entering the contract with insurer. If the insured have any uncertainties and doubts in the terms of agreement, he need to clarify them before accepting the insurance offer. The insured person cannot be provided with an option to bargain on the conditions. Insurer has a statutory obligation to be clear in its terms in the contract to the insured. If the insured agreed on the terms and conditions of the contract, there after he should adhere to those conditions.

4. Unilateral Contract

Insurance is considered as an unilateral contract as only one should be accountable for the legal actions in the contract. Insurer should not force the insureds to pay premium and to agree upon the conditions. Insurer cannot be held liable for the loss incurred if the insured violated any of the conditions mentioned in the contract.

Q17. What are the terms of Insurance Contract?

Answer :

The provisions of Indian Contract Act, 1872 are also applicable to the insurance contracts. To form a valid contract, the Section 10 of the Indian contract act provides the following conditions,

1. Offer and Acceptance

Generally, the insured (proposer) makes an offer for entering into the contract of insurance. It is also possible that insurance company may also make the offer to contract. For a valid acceptance, the agreement should fulfil all the requirements specified by the Indian Contract Act, 1872.

Any act that precedes the acceptance is an offer or a counter offer. An invitation to offer is something that precedes the offer or counter offer. The example of invitation to offer in an insurance company includes the publication of prospectus and the canvassing of the agents. An offer is when a proposer is willing to make a contract and if any alteration takes place in an offer, then that would be a counter-offer. Consequently, if the counter offer is accepted by the proposer, then it would be an acceptance. If there is no counter-offer the acceptance of an offer will be regarded as the acceptance by the insurer. It will be valid acceptance, when the notice of acceptance is immediately given to the other party.

Once the proposal is accepted by the insurer, there forma a valid and binding contract. The proposer may or may not accept the offer, if the insurer specifies a greater premium than the normal premium. To ensure a binding insurance contract, both the parties should agree on each and every material term that affects the agreements.

A valid and binding contract forms in life insurance, only when the first premium is paid. It is necessary that all Insurance Contracts are in writing and should meet the conditions of the Indian Stamp Act. An oral or informed contract allows the insurer to look for a stamp policy even after the occurrence of loss in the view of the Indian Stamp Act, 1899.

2. Legal Object

For a contract to be valid, the object of the agreement must be lawful and should not be restricted by any law. The subject matter of any contract is considered lawful only if,

(i) The contract is not prohibited by law.

(ii) The contract is not immortal.

(iii) The contract is opposed to public policy.

(iv) The contract that does not deny the provisions of any law.

It is necessary that the subject matter of insurance in the proposal form should be legal and also the consideration should be legal. The contract becomes void if the contract defrauds the insurance company on the basis of principles of Indemnity.

3. Mistake and Misrepresentation

An Insurance Contract is considered as contract of Uberrimae Fidei (i.e Principle of Utmost good faith). If this principle is not taken into consideration by one party, then the other may avoid it.

4. Capacity to Contract

The Indian Contract Act 1872, has specified certain rules relating to the contractual capacity of the parties. These rules are also applicable to insurance contracts.

The law states that every person is competent to contract,

(i) Whose age is of majority as per the law?

(ii) Who has sound mind?

(iii) Who is not disqualified by law from making a contract?

The capacity of an insurer to enter into insurance contract depends mainly on its constitution.

The law does not permit a minor to make a contract and the contract with a minor is unacceptable. However, an insurer can issue a policy on the minor's life in certain conditions/circumstances. The insurance contract under the system of deferred assurance policies, is made with a parent or legal guardian who is competent to contract.

5. Consideration

In the Contracts of Insurance, consideration is generally a premium to be paid by the insured and a promise to compensate on the part of insurer as per the terms and conditions of the policy. The premium is the price paid by the insured to the insurer for undertaking the risk.

Amount of premium is not a criteria, but the contract becomes void if the premium is not paid.

6. Free Consent

There must be a free consent of the parties entering into the contract. The consent should be free from,

(i) Undue influence

(ii) Coercion

(iii) Fraud

(iv) Mistake or

(v) Mispresentation.

If the consent is not free except fraud, then the contract becomes, voidable at the option of the parties whose consent is taken. The contract becomes void if there is a fraud. The proposal for free consent should sign a declaration to this effect. A written declaration should also be made by the person explaning the proposal's subject matter to the proposer. It is necessary for the proposer to disclose all material information and sign a declaration in the proposal. Addition to this, the product details should also be disclosed by the insurer.

4.8 FUNCTIONS OF INSURERS

Q18. Explain the concept of insurance and state the functions of insurers.

Answer : *(Model Paper-II, Q9(a) | April/May-15, Q5(b))*

Concept of Insurance

According to the commission on insurance terminology of the ARIA, insurance is defined as, "The pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insureds for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk".

Functions of Insurer

The following are the various functions or operations performed by the insurance companies (insurers),

1. Production

The main function of an insurer is to retain and secure the applicants in order to maintain the operational ability of the firm. Production function in an insurance firm is similar to that of sales/marketing in other sectors. As insurance is an intangible product, it is not possible to realise the sales before selling the policy. Insurance company have a production sales management department to manage the relations with agents and customers. They need to recruit, train and monitor the performance of sales executives/agents.

2. Underwriting

The process of identifying and classification of the risks involved in the insurance policies is termed as underwriting. Insurer should act as an underwriter to select the qualified applicants with minimum risk. Applicants with risk less than average standards can be offered the insurance polices. In property and liability insurance agents are provided with an underwriting authority whereas, in life insurance policy agents are mostly not provided with underwriting activities but they need to assess the risks associated with prior to their screening by actual underwriters.

3. Rate Making

Insurer acts as a rate maker to determine the rate/price of insurance policy. Rate/price of insurance is determined base on the costs involved in production of insurance and future predictions but it is not possible to determine the cost of production for insurance contracts till sales. Rate making is the process of forecasting future losses and expenses of the insurance policies and their distribution among the insured persons.

4. Managing Losses and Claims

Insurer should indemnify the losses that the members of a group have incurred. Settlement of losses or claims do not mean only payment of money to insured but also involve a complex process more than the payment. The insurance company should maintain a claim department which is involved in settlement of losses. Claim representatives of an insurance company may be either salaried employees or contractors.

5. Investing

Insurers will receive funds in the form of premium from the policy holders and he need to pay the total amount at the end of maturity period. Along with these funds, insurer also have paid-up capital, surplus loss reserves etc. Insurers should maintain an investment department in order to manage these funds and their investment using proper medium as the income from these investments constitute the profit of an insurer.

6. Financing

Insurer also acts as a financial manager to plan, monitor and control the supply of funds. Most of the insurers use profit as a source of funds to meet the financial requirements of the firm instead of outsider funds. Insurer is also involved in resolving the problems in financial aspects of the firm and need to determine the activities like, (i) Dividend policies (ii) Solvency requirements (iii) Long term and short-term account negotiations.

7. Accounting and Record Keeping

Insurer also acts as an accounting manager to assist the management in formulating the policies by recording, analysing, classifying and interpreting the financial data of the company. The accounting functions of an insurer are similar to those of other firms. Financial reports of insurance sector should follow separate accounting standards called Statutory Accounting Principles (SAP).

8. Miscellaneous Functions

The miscellaneous functions of an insurer includes,

(i) Legal Advisor

Insurer acts as a legal advisor to guide the underwriter to frame the policies and endorsements according to the rules and regulations. It is necessary to maintain a legal advisor to resolve the disputes regarding the claims and other legal issues associated with the polices.

(ii) Marketing Research

Insurer acts as a marketing research manager in order to direct the production department in planning the market activities.

(iii) Engineering Services

Insurer needs to perform the engineering activities in order to assist the rate making and underwriting activities.

(iv) Human Resource Management

Insurer as a human resource manager is required to perform the activities like recruiting employees, conducting training and education programs, implementing compensation and fringe benefit programs, maintaining employee's records, terminating employees etc. Most of the companies maintain a separate HR department to carryout all these activities.

4.9 TYPES OF INSURERS

Q19. Explain in detail the different types of insurers.

Answer : *Model Paper-III, Q9(b)*

Insurers are categorized into many groups based on the type of insurance, status of licensing, legal form of ownership, place of incorporation or marketing systems.

(a) Classification Based on the Type of Insurance

Based on the type of insurance product, insurers are categorized into a three types,

(i) Life Insurers

Insurers who are engaged in selling life insurance policies are called life insurers. In addition to life insurance policies, life insurers also sell annuities and health insurance policies.

(ii) Property and Liability Insurance Companies

Insurers who are engaged in selling property and liability insurance are called property and liability insurers.They do not consider the health insurance contracts.

(iii) Health Insurers

Insurers associated with health insurance are called health insurers or speciality insurers. They emphasize more on one area of risk. Some groups of speciality risks are included in property and liability insurance.

(b) Classification based on the Place of Incorporation and License

Based on the place of incorporation, insurers are categorized into three types,

(i) Domestic Insurer

Domestic insurer is an insurer who has incorporated the insurance company in their local state and under the law of that state.

(ii) Foreign Insurer

Insurer who has incorporated the company in another state and under the law of other state is called foreign insurer.

(iii) Alien Insurer

Insurer of one country who has incorporated the company in other country is called alien insurer.

Insurers are classified into two types based on the licensing status of an insurer.

1. Licensed Insurer

An insurer who has been granted licence for proceeding insurance operations in a particular state is called licensed insurer.

2. Unlicensed Insurer

An insurer who has not been granted licence for proceeding insurance operations in a particular state is called unlicensed insurer.

The licensed insurance agents should represent only licensed insurer.

(c) Classification based on Legal form of Ownership

Based on the legal form of ownership, insurers are classified into six types,

(i) Stock Insurers

The insurance companies in which the ownership is held by the stock holders are called stock insurers. Stock holders share the profits and losses of the stock insurers.

(ii) Mutual Insurers

The insurance companies in which the ownership is held by policy holders are called mutual insurers. Unlike stock insurers, in mutual insurance companies, policy holders select the board of directors to operate the mutual insurance company.

(iii) Reciprocals

Reciprocals are the private multiple line insurers which are not incorporated. Reciprocals consist of a group of individuals called "subscribers". Reciprocals are also called "interinsurance companies".

Reciprocals are of two types,

1. **Pure Reciprocals**

   Pure reciprocals are the traditional reciprocals for which separate account should be maintained for each subscriber to credit the premium and profit share and to debit the shared losses and expenses.

2. **Modified Reciprocals**

   Modified reciprocals are the modern reciprocals which are similar to advance premium mutual insurer except in having an administrator.

(iv) Lloyd's Association

Lloyd's associations provide a source of insurance contracts but do not include underwriting activities. They are of two types,

1. **Lloyd's of London**

   Lloyd's of London are the professional insurers offering ocean marine insurance across the world. They can take variety of risks associated with the insurance contracts.

2. **American Lloyd's**

   American Lloyd's are similar to Lloyd's of London which consist of a group of private underwriters of America.

(v) Health Expense Associations

Health expense associations are associated with health insurance contracts and include two types of associations. They are,

1. **Blue Cross Association**

   These are non-profit organizations associated with the advance payment of expenses incurred for hospital services. These associations are licensed under the law of the state.

2. **Blue Shield Plans**

   These associations are also non-profit organizations associated with the advance payment of the physician expenses, surgeon fees etc. These are licensed under the law of states and by the local physicians.

(vi) Government Insurers

Federal and state government offer number of insurance programs to individuals including social insurance and private insurance. The private insurance programs offered by federal government include post office insurance coverages, federal crop insurance, mortgage loan insurance, national flood insurance program etc.

Similarly, the private insurance programs offered by state government include worker's compensation insurance, state life insurance, state automobile insurance fund etc., to meet the claims of the society.

4.10 REINSURANCE

Q20. What is Re-insurance? Write briefly about its characteristics.

Answer :

Reinsurance

Reinsurance is termed as insurance for an insurer or insurance company. Most of the insurance companies are willing to share the risk of bearing high losses of insureds with other insurers, which is called reinsurance. In simple words, sharing the risk with other insurers in order to avoid catastrophic effect or hazards in insurance. Reinsurance is most commonly observed in general life insurance companies. In return of risk insurers need to pay a premium to reinsurer.

Characteristics of Reinsurance

Re-insurance contract has the following characteristics features,

1. Insurance contract
2. Follows insurance principles
3. Restricted to the boundaries of re-insurance
4. Insurer holds the basic liability and
5. Re-insurance termination.

1. Insurance Contract

Re-insurance is a kind of insurance contract, which is followed by the insurer for spreading their loss, particularly in the case where the risk levels are very high with respect to insurance.

Example

XYZ insurance company insures a building for ₹ 20 crore. As the insurance amount is huge, XYZ company may reinsure the building upto 10 crore with ABC insurance company.

Thus, in case of loss, XYZ company would pay ₹ 20 crore to the owners and then it can claim resinurance amount of ₹ 10 crore from ABC insurance company.

2. Follows Insurance Principles

The principles which the re-insurance contract would follow are similar to that of the principles of original insurance contract only in except few cases where any special principles are added in the re-insurance contract.

3. Restricted to the Boundaries of Re-insurance

Reinsurance contract is made within the boundaries of the original insurance contract, that is, the insurer can re-insure the contract upo the degree of risk which is taken by him with respect to the contract of insurance. Thus, the insurer cannot exceed the limit of contract while re-insuring.

Example

XYZ insurance company insures a building for ₹ 5 crore. It means that it can reinsure the building only to the extent of ₹ 5 crore and not more than this.

4. Insurer holds the basic Liability

In the contract of reinsurance, it is the original insurer (insurance company) who has to pay the sum of assured amount to the insured person. Later on, it can recover the share of his liability from the re-insurer.

5. Re-insurance Termination

A contract of re-insurance would get terminated whenever the original contract of insurance collapses due to any of the reasons.

Q21. Explain different types of reinsurance.

Answer :

Reinsurance is classified into two treaties namely facultative and automatic treaties.

1. Facultative Reinsurance Agreement

Facultative reinsurance agreement is of two types, i.e, formal and informal.

(i) Formal Facultative Reinsurance

It came into force at the interest of reinsurer. In this reinsurance agreement, insurer is required to notice certain risks involved in a policy to the reinsurers.

(ii) Informal Facultative Reinsurance Agreement

Informal facultative agreements are specific insurance agreements.

2. Automatic Treaty

In this type of reinsurance agreement, reinsurer is required to agree upon the certain percentage of risks of insurer he is willing to share as per the guidelines of reinsurer's underwriting policy.

Reinsurance agreements are further categorized into two types, based on the type of insurance it is applied to,

(a) Reinsurance in property and liability insurance

(b) Reinsurance in life insurance.

(a) Reinsurance in Property and Liability Insurance

These are the reinsurance agreements associated with property and liability insurance contracts. These are included under two treaties,

(i) Proportional treaties

(ii) Excess-loss treaties.

(i) Proportional Treaties

In these treaties, the loss and premium should be shared proportionally among the parties. The two important treaties under this category are,

(a) Quota Share Treaty

In this treaty, both reinsurer and insurer agree upon the shared proportion of the risk to each party.

(b) Surplus Treaty

In this treaty, reinsurer will accept the surplus loss of insurer i.e., net retention of insurer.

(c) Pooling

Pooling method is similar to that of quota share treaty. In this, all the insurance companies form a pool to share the risks among them.

(ii) Excess-loss Treaty

In this treaty, reinsurer will pay the losses only if they exceed a predetermined amount. There exists no direct relation between the net retention limit and the amount paid by reinsurer. These treaties are sufficient for specific conditions.

(b) Reinsurance in Life Insurance

These reinsurance agreements are associated with life insurance policies. The two approaches under this category are,

(i) Insurance approach

(ii) Coinsurance approach.

(i) Insurance Approach

In this approach, insurer purchases the life insurance policy which is renewable whose worth is equal to the risk amount of his company [Risk amount = Face value of policy – Reserves]

(ii) Coinsurance Approach

In coinsurance insurer seeks the reinsurance to share the face value of the policy and the reinsurer should also bear the maintenance costs of his share.

Q22. Explain the importance of reinsurance to insurers.

Answer :

The importance of reinsurance to insurers are in the following ways,

(i) Enhances Financial Capacity

Insurer accepts the risk associated with the insurance policies within its financial limits or retention lines. Beyond this limit, he cannot take the risk of recovering the loss to insured. In order to sustain competition in business, insurer should accept the total risk and then share it with the other insurers called reinsurers. Reinsurance simplified the procedure of insurance contracts. Reinsurance provide an assurance to the policy holders about the insurer's liability for losses.

(ii) Stabilises Profit and Loss Ratios

Reinsurance stabilises the profit and loss ratio. In order to sustain in long run, insurance companies should maintain a lower and stable profit level/ratio and underwrite losses incurred instead of the higher and unstable profits. Though reinsurance cannot completely minimize the profit and loss ratio, it can stabilise the fluctuations/variations in the profits over a period of time.

(iii) Avoids the Maintenance of Unearned Premium Reserves

Reinsurance enhances the profitability of small and new companies by reducing the unearned premium reserves by the insurers, as maintenance of reserves for unearned premiums from investors drains the surplus profits of the insurers in terms of sales commission and other underwriting expenses. In reinsurance, insurer can transfer the liability for loss and the maintenance of unearned premium reserves to reinsurer. For maintenance of business on books, reinsurers pay a commission to insurers which covers a part of the unearned premium reserves of insurer. Continuous reinsurance will enhance the surplus of the insurers by minimizing the costs and expenses.

Example

If an insurer transfers ₹ 2,00,000/- to reinsurer from its unearned premium reserves then the reinsurer will pay 50% of the amount to insurer as a commission which results in a decrease in assets by ₹ 1,00,000/- and liabilities by ₹ 2,00,000/-. Then the profit gained by insurer will be ₹ 1,00,000.

(iv) Retirement from Underwriting

In case of liquidation of business or insurance company, insurer needs to pay the unearned premium to the investors at the cost of his profits which is not desirable in any business. Under reinsurance, insurer can transfer the liability for loss and coverage to the reinsurers and can easily get retirement from the insurance business and underwriting activities. As it is not possible to cancel the life insurance policies, reinsurers will protect the investors and take the liability to pay the loss to insured's.

4.11 PROSPECTS OF INSURANCE COMPANIES

Q23. Discuss the future prospects of insurance companies.

Answer : *Model Paper-II, Q9(b)*

There has been a development and growth in insurance sector all over the world. In India, insurance sector is considered as the most favoured investment destination. Among the global insurance companies, India ranks 5th largest insurance market. People are showing a great interest towards insurance sector. The liberalization policies in this sector, are allowing the private sector insurance companies to enter into the market. As a result of this, the growth is apparent in the number of players operating in the market. This competition has lead to the development of new products, enhanced customer service, better packaging and increased employment opportunities.

The government is taking necessary steps to improve the existing laws as to enable the insurance industry to perform in line with the global expectations and trends. The industry is growing and is expected to grow more in the near future. The prospects of insurance sector in India can be understood under the following heads,

1. Market Structure

In September 2011, there were around 49 insurance companies operating in India. Among these 49 companies, 24 companies are in life insurance, 24 companies are in general insurance and the remaining companies are operating in re-insurance business. According to a report by Boston Consulting Group (BCG). The sector is growing with a rapid pace and expected to reach around US $400 billion in premium income by 2020. The report states that India will be one of the top three life insurance companies and top 15 non-life insurance companies by the end of 2020.

2. Career Prospects

Indian insurance sector has become a source of multiple career opportunities. It provides jobs in various fields like marketing, actuarial, distribution, underwriting, operations and investing departments.

A graduate specialized in the area of marketing, sales or finance can easily grab the opportunities available in insurance companies. They can earn upto ₹ 20,000/month. The companies provide a good renumeration and high incentives to retain the qualified employers.

3 Recent Initiatives

The Securities and Exchange Board of India (SEBI) has developed flexible rules to enable the life insurance companies to launch public offers. To promote this sector, the finance minister has raised FDI in insurance and pension sectors to 49% from the current 26%. Besides this, the governments financial sector legislative reforms commission is putting all efforts to develop a framework that would encourage LIC's monopoly, setup a legal system and empower IRDA to manage any lapses that occur in the insurance.

4. Future Growth

There is a remarkable growth in Indian insurance industry with many national and international players competing in the country. In 2012, a report by Mckinsey predicted that the growth in insurance industry is mainly due to various factors like growing technology, higher premiums, increasing income of households, liberal policies, growing technology etc. This any result in several more opportunities in the future.

In the coming years, the insurance market may witness a tremendous change in the marketing mix i.e., Product, place, price, promotion and communication. The market will show a great concern towards customers, leading to a lot of flexibilities and innovations.

The insurance companies are required to develop new strategies for the modern distribution channels such as the electronic media, the bancassurance, electronic media and the internet.

The Asian markets have played an important role in the development of insurance sector. The Indian markets are providing several opportunities for growth and outperforming the already saturated markets. It is expected that the mergers and acquisitions will be more in the near future.

4.12 OVERVIEW OF IRDA

Q24. Write about IRDA and discuss the objectives, duties and powers.

Answer :

IRDA

Insurance Regulatory and Development Authority (IRDA) was established based on the recommendations of R.N. Malhotra Committee. After considerable discussion on the subject matter, the insurance bill was presented in both parliament houses. Thereafter, the government passed the Insurance Regulatory and Development Authority (IRDA) Act, 1999. This act aims at opening up the insurance sector for private companies with a 26% of foreign equity. It seeks to finish the monopoly of the general insurance corporation and life insurance corporation in the insurance sector.

Objectives of IRDA

The main objectives of IRDA include the following,

1. To protect the interest of the investors or the policy holders.
2. To facilitate the entry of private firms into the insurable industry.
3. To ensure consistent financial soundness and solvency of the insurance companies.
4. To provide assistance to the insurance firms for formulating the new policies according to the customer preferences.
5. To monitor and control the insurance and reinsurance companies.
6. To avoid dishonest and unfair competition among the firm's dealing with insurance business.
7. To monitor the functions of an insurance agent and a broker.
8. To amend the insurance acts for various policies according to the varied circumstances.
9. To establish guidelines for agents/brokers.
10. To issue authorised licences to the newly established insurance companies in an insurance industry after examining their suitability and financial soundness.
11. To establish guidelines for the functioning of the insurance operations.
12. To ensure transparency and clarity in the functioning of insurance companies.
13. To build an effective infrastructure for proper monitoring and maintenance of the insurance firms.

Duties and Powers of IRDA

The duties and powers of the IRDA are as follows,

1. It controls, promotes and makes sure that there is a growth in insurance business.
2. It controls and encourages the professional organizations which are associated with insurance business.
3. It exercises all the functions and powers of the controller of insurance.
4. It is the duty of IRDA to protect the policy holder's interest in settling the claims and terms and conditions of policies.
5. It manages the investment of funds.
6. It manages the solvency margins.
7. It resolves the disputes arising between intermediaries and insurers.
8. It inspects and carries out investigation including audit of intermediaries, insurer and other organizations involved.
9. It specifies the form and manner in which the accounts are required to be maintained and submitted both by intermediaries and insurers.
10. It controls the terms and conditions and the rates offered by the insurance companies related to general insurance matters.

Q25. Write a brief note on IRDA's regulatory.

Answer : *(Model Paper-III, Q9(a) | May/June-17, Q5(b))*

IRDA plays a role of a regulator for the insurance industry in India. The role of IRDA in insurance business can be understood from the following points,

(a) Issue of Directions

IRDA is found to follow the directions issued by the government on different issues related to insurance policies other than the technical or administrative nature.

(b) Supersession

Further, the government has right to supersede the IRDA for a period not exceeding six months with prior notification. During the supersession of IRDA, the government may appoint a Controller Of Insurance (COI) as per the Insurance Act. 1938. The supersession may be due to the following reasons.

(i) If IRDA is unable to perform its functions due to circumstances beyond its control.

(ii) If IRDA persistently fails to comply with the given direction under the IRDA Act resulting in a weaker financial position.

(iii) Under circumstances that call for supersession to protect public interest.

(c) Insurance Advisory Committee

The IRDA can also establish a committee of 25 members called IAC. The committee would represent the interest of commerce, industry, consumer forum, agents, intermediaries etc., on regulation matters.

(d) Amendment of LIC Act, 1956

IRDA amended the LIC Act ceasing its monopoly and opening the life insurance sector for the Indian private insurance companies. Foreign participation in these companies should not exceed 26% of the paid-up capital. The main function is to carry on general/life insurance business.

(e) Amendment of GIC Act, 1972

IRDA also amended GIC Act to allow private players enter the insurance sector breaking the monopoly of the GIC and its four subsidiaries.

(f) Amendments to Insurance Act, 1938

The IRDA also made amendments to the insurance Act, 1938 to update the provisions to suit changing scope of insurance and for smooth and efficient running of the insurance industry.

SHORT QUESTIONS AND ANSWERS

Q1. Types of Insurance

Answer : *(Model Paper-III, Q2 | May/June-17, Q1(h))*

Insurers are categorized into many groups based on the type of insurance, status of licensing, legal form of ownership, place of incorporation or marketing systems.

(a) Classification Based on the Type of Insurance

Based on the type of insurance product insurers are categorized into a three types,

(i) Life insurance companies/life insurers

(ii) Property and liability insurance companies

(iii) Health insurers.

(b) Classification based on the Place of Incorporation and License

Based on the place of incorporation insurers are categorized into three types,

(i) Domestic insurer

(ii) Foreign insurer

(iii) Alien insurer.

(c) Classification based on Legal form of Ownership

Based on the legal form of ownership insurers are classified into six types,

(i) Stock insurers

(ii) Mutual insurers

(iii) Reciprocals

(iv) Lloyd's associations

(v) Health expense associations

(vi) Government insurers.

Q2. Write about insurable interest and subrogation. *Model Paper-I, Q4*

OR

Insurable Interest *(April/May-15, Q1(g) | April/May-14, Q1(g))*

(Refer Only Topic: Insurable Interest)

OR

Subrogation

(Refer Only Topic: Subrogation)

Answer : *April/May-15, Q1(h)*

Insurable Interest

According to Reigal and Miller, "An insurable interest is an interest of such a nature that the proposes would be financially injured by the occurrence of the event insured against".

According to Mac-Gillivary, insurable interest means "where the assured is so situated that happening of the event on which the insurance money is to become payable would as a proximate result, involve the assured in the loss or diminution of any right recognized by law or any legal liability there is an insurable interest in the happening of the event the extent of the possible loss or liability".

Subrogation

Principle of subrogation is one of the legal principles of insurance contract and supports the principle of indemnity. This principle provides the benefit to insured to claim the insurer for any loss incurred due to the negligence of third party. The insurer then can proceed against the third party to recover the loss paid to the insured.

Example

If '*x*' incurred damage to his car due to the negligence of '*y*', then the insurer of '*x*' will pay the loss amount to '*x*' and then collect that amount from the '*y*'.

Q3. Define reinsurance. What are its advantages?

OR

Reinsurance *April/May-14, Q1(j)*

(Refer Only Topic: Reinsurance)

OR

Advantages of Reinsurance

(Refer Only Topic: Advantages of Reinsurance)

Answer : *(Model Paper-II, Q3 | May/June-16, Q1(g))*

Reinsurance

Reinsurance is termed as insurance for an insurer or insurance companies. Most of the insurance companies are willing to share the risk of bearing high losses of insureds with other insurers, which is called reinsurance. In simple words, sharing the risk with other insurers in order to avoid catastrophic effect or hazards in insurance. Reinsurance is most commonly observed in general life insurance companies. In return of risk insurers need to pay a premium to reinsurer.

Advantages of Reinsurance

Reinsurance is more advantageous to insurers in the following ways,

(i) It enhances the financial capacity of the insurers.

(ii) It stabilizes the profit and loss ratios.

(iii) It minimizes the burden of unearned premium reserves.

(iv) It allows insurer to relieve from underwriting processes or to retire from the insurance business.

Q4. Underwriting

Answer : *(May/June-13, Q1(d) | May/June-12, Q1(g))*

The process of identifying and classification of the risks involved in the insurance policies is termed as underwriting. Insurer should act as an underwriter to select the qualified applicants with minimum risk. Applicants with risk less than average standards can be offered the insurance polices. In property and liability insurance agents are provided with an underwriting authority whereas, in life insurance policy agents are mostly not provided with underwriting activities but they need to assess the risks associated with prior to their screening by actual underwriters.

The following are the objectives of an underwriter in insurance sector.

(i) To minor the selection process of applicants in order to avoid unqualified applicants.

(ii) To minimize the risks and losses associated and to maintain the actual losses within the range of expected losses.

(iii) To secure appropriate number of exposure units in each class.

(iv) To secure the exposure units from the catastrophic effect.

Q5. Utmost Good Faith

Answer : *May/June-12, Q1(f)*

Insurance contracts involve information asymmetries between parties. Generally, the insured has a better idea about the risk to be insured than the insurer. In order to balance this, the law specifies that both the parties should disclose any information important to the contract. The principle of utmost good faith specifies that both the parties should openly and honestly disclose the information without concealing any material facts that may affect the judgement of the other party.

Example

If a person is applying for a life insurance, he should disclose all his previous health problems. In the similar manner, the insurance agent who sells the coverage should also disclose all the important information relating to the contracts and its items.

The duly to act in good faith applies to all kinds of insurance contracts. The maxim 'Caveat Vendito' is applied in the contracts of sale, which means 'let the buyer beware'. This maxim compels the buyer to have sufficient information and take necessary steps in buying an item. The buyer should know whether the product meets his expectations or not. This maxim is not applicable in insurance.

Q6. IRDA

Answer : *May/June-12, Q1(j)*

Insurance Regulatory and Development Authority (IRDA) was established based on the recommendations of R.N. Malhotra Committee. After considerable discussion on the subject matter, the insurance bill was presented in both parliament houses. Thereafter, the government passed the Insurance Regulatory and Development Authority (IRDA) Act, 1999. This act aims at opening up the insurance sector for private companies with a 26% of foreign equity. It seeks to finish the monopoly of the General Insurance Corporation and Life Insurance Corporation in the insurance sector.

INTERNAL ASSESSMENT

I. Multiple Choice

1. Which one of the following is not a function of insurer? [ ]
   (a) Production
   (b) Rate making
   (c) Managing losses and claims
   (d) None of the above
2. _________ risk is considered as uncontrollable risk. [ ]
   (a) Price risk
   (b) Political risk
   (c) Pure risk
   (d) Credit risk
3. The insurer which is owned by a parent firm for the purpose of insuring the parent firms loss exposures. [ ]
   (a) Stock insurer
   (b) Captive insurer
   (c) Mutual insurer
   (d) All of the above
4. A contract of insurance is a contract uberriae fidei i.e., based on_________. [ ]
   (a) Principle of subrogation
   (b) Principle of utmost good faith
   (c) Principle of proximate cause
   (d) Principle of contribution
5. The insurance company in which ownership is held by policy holders is called, [ ]
   (a) Mutual insurance company
   (b) Stock insurer
   (c) Reciprocals
   (d) Lloyd's of London
6. _________ provide a source of insurance contracts but donot include underwriting activities. [ ]
   (a) Mutual insurer
   (b) Stock insurer
   (c) Lloyd's of London
   (d) Government insurern
7. IRDA means, [ ]
   (a) Indian Rural Development Authority
   (b) Insurance Regulatory and Development Authority
   (c) Insurance Rural Development Authority
   (d) Insurance Revenue Development Authority

8. Subrogation and indemnity principles are not applicable to, [ ]
   (a) Life insurance (b) Property and liability insurance
   (c) General insurance (d) Health insurance
9. The amandments made by IRDA in which of the following acts? [ ]
   (a) GIC Act, 1972 (b) LIC Act, 1956
   (c) Both (a) and (b) (d) MRTP Act
10. Which one of the following is not a feature of insurance contract? [ ]
   (a) Aleatory contract (b) Unconditional contract
   (c) Unilateral contract (d) Contract of adhesion

II. Fill in the Blanks

1. ______ is the pooling of forfeitous losses by the transfer of risk of insured to insurer.
2 The risk that influences an individual directly is called as ______.
3. ______ means restoring the insured to his financial position by compensating all the losses.
4. ______ is a legal term that describes how exactly the loss occurred.
5. The process of identification and classification of the risks involved in insurance program is called ______.
6. ______ is the price paid by the insured to the insured to the insurer for undertaking the risk.
7. ______ is called insurance for insurers.
8. ______ is the process of identifying or analyzing evaluating, monitoring and controlling the risk and financial resources.
9. The Latin word 'Uberrima Fides' means ______.
10. In ______ treaty, both insurer and reinsurer agree upon the shared proportion of the risk to each party.

KEY

I. Multiple Choice

1. (d) 2. (c) 3. (b) 4. (b) 5. (a)
6. (c) 7. (b) 8. (a) 9. (d) 10. (b)

II. Fill in the Blanks

1. Insurance
2. Personal risk
3. Indemnification
4. Proximate cause
5. Underwriting
6. Premium
7. Reinsurance
8. Risk management
9. Utmost good faith
10. Quota share treaty.

III. Very Short Questions and Answers

Q1. Define Insurance.

Answer :

According to the commission on insurance terminology of the ARIA, insurance is defined as, "The pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insureds for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk".

Q2. What is Rate Making?

Answer :

Rate making is the process of forecasting future losses and expenses of the insurance policies and their distribution among the insured persons.

Q3. Define Risk Management.

Answer :

Risk management is the process of identifying, evaluating, monitoring and controlling the risk and financial resources inorder to reduce the adverse effects of loss in the business.

Q4. What do you mean by Particular Risk?

Answer :

The risk which impacts only certain individuals and not the whole group or community is known as particular risk. It does not affect the whole community, rather it only affects the individuals related to such losses.

Q5. Define Insurance Contract.

Answer :

An Insurance Contract is nothing but an agreement between insured and insurance company (ie insurer) and has to comply with the provisions of the Indian Contract Act, 1872. The main purpose of creating insurance contract is to transfer a part of the risk of loss from insured to the insurer.

UNIT 5

Life Insurance and General Insurance

LEARNING OBJECTIVES

After studying this unit, one would be able to understand,

- Concept of Life Insurance and its Features.
- Life Insurance Products including Pension Plans, Group Insurance and Insurance for the Underprivileged.
- Tax treatment carried out for Life Insurance.
- Claim Settlement – Types of Claims and its Procedure.
- Meaning of Distribution Channel – Roles and Responsibilities of Agents and Brokers.
- Concept of General Insurance and its Types.
- Concept of Health Accident, Motor, Fire, Credit and Crop Insurance.

INTRODUCTION

The insurance that pays death benefits to the beneficiaries after the death of the insured is known as life insurance. Pension plans are offered by insurance companies helps the individuals in planning their retirement period. It provides regular income to individuals after their retirement. Group insurance is provided to many people belonging to a group like, members of an association in an organization to improve their productivity and morale.

Claim settlement means paying back the money by the insurance company to the insurance policy holder. A claim is said to be settled when policy holder duly receives the money which is due to him the company as per the terms and conditions of policy.

IRDA introduced variety of intermediaries like agents and brokers to help the insurer to fulfill their objectives to reach various market segments. It is referred as distribution channel.

General insurance refers to insurance products excluding the life insurance. It can be insurance of property, motor vehicle, accident, crop and credit.

5.1 THE CONCEPT OF LIFE INSURANCE

Q1. Define life insurance. Discuss the various aspects/features of life insurance.

Answer :

Life Insurance

The insurance that pays death benefits to the beneficiaries after the death of the insured is known as life insurance. These benefits are used to cover up funeral expenses, uninsured medical bills, estate taxes and few other expenses. The benefit can also be a regular income payments to the insured's beneficiary. The life insurance also includes retirement plans that pay benefits after retirement.

Aspects/Features of Life Insurance

(a) Nature of General Contract

Sec 2(h) and sec 10 of the Indian Contract Act states the essentials of life insurance contract as follows,

1. Offer and Acceptance

The offer and acceptance for the contract should also be valid i.e., the contract should be made between the applicant and insurer, but not between agents or representative of both.

- Incase of property insurance policies, local agent will be provided with the authority to accept the offers by the insurer. These contracts will be cancelled if the insurer is willing to escape.
- In case of life insurance policies only the insurer has the authority to accept the offer and issue the counter offer.

  The insurer/agent will accept the offer from an applicant after determining the ability of applicant to satisfy the requirements of insurance agreement by the head office/insurer. Insurer will issue a conditional receipt after determining the insurability of the applicant and also issue the tender of first premium. Once the applicant paid the first premium and died before the completion of the processes, the beneficiary of the applicant can claim for the amount. As the offer can be considered as valid after receiving the first premium from the insured.

2. Legal Relationship

The parties of an agreement should have an intention to establish a legal relationship between them. If such intention does not exist then a contract cannot be formed.

Agreements of social or domestic type cannot be considered as contracts as they will not fulfill the legal obligations. The Insurance contract must be basically formed with an objective of creating legal relationship between the insurer and insured.

3. Capacity of the Parties

The parties involved in the insurance contract should possess legal capacity to perform the contract i.e., they should not possess any illegal ventures. The persons such as insane persons, intoxicated persons, minor are not eligible to enter a valid contract. Minors at an age of 14 1/2 can enter an insurance contract.

4. Valid Consideration

Both the parties involved in insurance contract should agree upon the consideration in the contract. Consideration of insured consists of premium to be paid to insurer and the conditions of contract. Whereas, consideration of insurer consists of indemnification to recover the loss to insured, to protect him in legal proceedings and other activities.

5. Free Consent

In order to make a valid contract the consent permission of both the parties (i.e., insurer and insured should be obtained willingly) i.e. the Free consent. It should not obtained by (i) Coercion (ii) Undue influence (iii) Fraud (iv) Misrepresentation and (v) Mistake. If the agreement is violated because of any of the above first four factors then the contract is said to be voidable.

6. Legality of object

The purpose of the insurance contract should be enforced by law i.e, it should satisfy the requirements of insurable interest and insured does not associated with any illegal activities / ventures.

(b) Utmost Good Faith

This means that both the parties are expected to disclose any information important to the contract. For example, if you are applying for life insurance you are required to disclose any previous health problems you may have. Likewise, the insurance agent selling you the coverage must disclose the critical information you need to know about your contract and its items.

(c) Insurable Interest

Principle of insurable interest is one of the legal principle of insurance contracts that supports the principle of indemnity. An insured should satisfy the requirements of insurable interest while collecting the amount by proving the loss due to insured peril. This doctrine prohibits the insurance contract from the act of gambling. This doctrine helps in minimizing the moral hazards and threat of willful destruction of property.

In life Insurance contract, insurable interest is classified into two types,

(i) Insurable Interest in One's Own Life

Under this, the insured is free to take up any policy for himself or for some one else. But this does not mean that the beneficiary of the policy must have any kind of interest in the life of the insured.

(ii) Insurable interest in Other's Life

Under this, the individual is free to insured the life of others.

Example

A Husband can insure the life of his wife. Similarly son can insure the life of his parents and children's. But it needs suitable proof for insuring the business and family relationship.

(d) Principle of Indemnity

The principle of indemnity states that the insurer should not pay more than the actual amount of loss. In other words, it states that the insured should not make profits from the loss incurred by him.

(e) Proximate Cause

The principle of Causa proxima states that insurer should pay the claim by taking into consideration the immediate cause and not the remote cause.

(f) Principle of Contribution

Doctrine of contribution is applicable for those goods which are insured with two or more insurance companies for the same contingent event. In case of damage, the loss need to be shared by both the companies in proportion of the amount which is insured by the company. Or else the insurer would make profit out of the loss by raising compensation from all the insurers.

(g) Warranties

It is a guarantee statement by its maker that all the facts stated in it, in all the respects are fair enough so that insured can avail the facility of an insurance against risk.

Q2. Explain the need and importance of life insurance.

Answer : *April/May-14, Q5(b)*

Need of Life Insurance

A Life Insurance policy is needed for the following reasons,

(i) Financial Security

Life Insurance policy provides financial security to the dependents of the policy holder in case of his/her death.

(ii) Dependents

A life insurance protection is required by those persons who are the only source of income for their family members and dependents. Example: Children, Old parents, Spouse etc.

(iii) Protection to Children's Future

It is also required to protect or safeguard the future of children in case of death of their parents. Even non-wages earning parents desire to protect the future of their children.

Importance of Life Insurance

Following points highlight the importance of life insurance policies,

(i) Receipt of Immediate Expenses

Life Insurance plays a significant role in the event of death of any policy holder. It helps the dependents of the policy holder in paying immediate death expenses such as Funeral services, Hospital bills, Mortgage payments and so on.

(ii) Tax-free Cash

It allows access to cash through which grocery and daily expenses can be paid. The cash which it provides is tax-free and the holders can use it for paying their estate and other obligations.

(iii) Standard of Living

Coverage of the policy at right time helps to maintain the standard of living of the family members.

(iv) Large Options to Choose

It offers various types of life insurance policies through which short term and long term benefits can be enjoyed by the holder and his/her dependents.

(v) Policy Customization

A policy holder can customize his life insurance policy at any time or may drop it entirely if he/she does not have any spouse or children or dependents.

(vi) Financial Asset

It is considered as a financial asset of the policy holder through which he can increase his credit score. This score will be beneficial while obtaining medical insurance loan.

5.2 LIFE INSURANCE PRODUCTS – TRADITIONAL AND MARKET RELATED

Q3. Explain various life insurance products. *May/June-13, Q6(b)*

OR

Explain the various types of life insurance products. *May/June-12, Q6(a)*

OR

Explain briefly the types of life insurance contracts. *April/May-15, Q6(a)*

OR

Explain the different types of life insurance contracts.

Answer : *(Model Paper-I, Q10(a) | April/May-14, Q6(a))*

Life insurance comprises the following different types of plans,

1. Term Plan

Term plan is the insurance that provides temporary protection to the insured for a limited term period. The term for protection may be either 1 year, 5 years, 10 years or 20 years. The term for insurance is decided on the expected life term of the insured, on the basis of mortality tables.

2. Endowment Plan

The endowment life insurance is a policy in which the insurer promises to pay the face amount upon the death of the insured and even on the survival of the insured at the end of the policy term. The policy term may be for 10 years or 20 years.

3. Money Back Insurance Plan

Money back policy is an endowment policy which is issued as a 'with profit policy'. The bonus will be given for entire sum assured for the whole term of policy in maturity claim.

4. Whole Life Insurance Plan

The whole life insurance is one of the permanent type of insurance and is effective till the insured's complete life time. Eventhough the total face value of the life insurance coverage is less than the term insurance, it contributes about half of the total life insurance policies sold in the United States.

5. Unit Linked Insurance Plans

Unit-linked insurance policies are those contracts wherein investor (policy holder) pay single premium or rarely pays recurring premium to an insurance company which utilizes the capital raised for investing in internal or external investment funds.

6. Joint Life Insurance Plans

Joint life plan given coverage to the lives of husband and wife only. If any one insured dies during the term then death claim of single sum assured is paid to the other and policy contract is cancelled. The sum assured will be paid to nominee or the survivors if both the insured die during the term.

7. Child Insurance Plans

It is an insurance policy taken by the parents on the lives of their children. The cover for death is provided when the child attains the age of 7 years. This policy is issued with a condition that, after attaining the vesting age i.e., 18 years, the title of the policy will automatically pass on to the child.

8. Industrial Life Insurance

The industrial life insurance has a face amount of less than $1000 and the premium is paid on a frequent basis, such as weekly. The industrial life insurance is usually sold in premium units rather than face amount. The collection of premium, from the home of the insured, by the company representative in the highlighting feature of the industrial life insurance.

9. MWP Policies

Married Women Property (MWP) Act, 1874 is suitable for all married women of any religion. This policy takes complete care of only wife and the children. In India, the MWP Act is not recommended by many of the life insurance policies.

10. Keyman Insurance

Keyman insurance is a life insurance plan offered to an employer to compensate the financial loss on the life of a key member of the organization. It provides a unique opportunity to secure the business from unfortunate loss of employee who acts as a keyman of the company. A keyman is referred as a skillful and efficient person who is responsible for the bank loan and repayments and generate profits over the years. It is very difficult for the employer to replace another person if the keyman dies.

5.2.1 Pension Plans – Types

Q4. Explain briefly about pension plans of insurance companies. What are its types and options available to individuals in pension plans?

Answer :

Pension Plan/Policy of Insurance Company

The pension plans offered by insurance companies help the individuals in planning their retirement period. These type of plans provide regular income to individuals after their retirement. On the date of maturity of pension plan, the plan will be generated or converted into a regular income which is known as 'Pension' or 'Annuity'. Tax benefits on pension plans is limited to ₹ 10,000 only.

Types of Pension Plans

The different types of pension plans or policies are as follows,

1. With Cover Plans

The pension plan which provide assured life cover or sum assured in case of any eventuality is referred as 'with cover pension plans'.

2. Without Cover Plans

In case of without cover pension plans, there will be no sum assured provided to the insured person. Person may receive the amount after the deduction of expenses and premium which is unpaired at the time of eventuality.

3. Immediate Annuity Plans

Under immediate annuity plans, the pension or annuity is provided to individual is one year only. Because premium payment is only one-time in this plan. Such a premium amount is known as purchase price. In India, only few companies are offering immediate annuity plans. One of the example is LIC's Jeevan Akshay-II.

4. Deffered Annuity Plans

Under deffered annuity plan, the pension or annuity does not occur immediately to the individual. The premium paid under this plan can be single or regular permium. In India, most of the pension plans offered by insurance companies are deffered annuity plans.

Options Available to Individuals in Pension Plans

Following are the various options available to individuals in pension plans,

1. Without Return of Purchase Price on Lifetime Annuity

In this option, the pension is received by the individual till he/she alives. The pension stops on occurrence of any death event. The purchase price of Annuity is not returned to the Individual or his dependents under this policy.

2. With Return of Purchase Price on Annuity for Life

Under this option, the pension is received by the individual till he/she alives . However, on occurrence of any death event , the annuity's purchase price is paid to the individual's nominees or beneficiaries purchase price will or be the amount of maturity which consists of basic sum assured along with bonus or additions (if applicable).

3. Guarantee of Lifetime Annuity for a Specific Number of Years

In this option, the pension for a specific number of years [as per mentioned in the plan] is received by the individual, regardless whether the individual is alive or not. The benefit of this option is that, incase the individual is alive or surrives for the mentioned period, then he/she will continue to receive the pension till the death of the individual.

4. Last Survivor or Joint Life Annuity

Under this option, the pension is received by the individual till he/she is alive. However, on the occurrence of an death event, the spouse of the individual will receive the pension.

Besides these options, many companies also offer policies which includes both with and without return of purchase price.

5.2.2 Group Insurance

Q5. What is Group Insurance? Discuss its importance to both employer and employees.

Answer :

Group Insurance

In group insurance, many persons belonging to a group like members of an association or employees in an organization are covered under one contract. The insurer and the group policy owner enter into a contract called 'master contract' for the benefit of the members of the group.

Group insurance operates at a great level and provide its benefits to a group of persons at a moderate cost. Group insurance has grown in recent years due to advancement of economy and consequential development of the organized sector. It acts as an instrument to implement the social security measures of the government. Group insurance has now became an essential part of life insurance business.

In 1911, a first group insurance policy was introduced by the equitable life assurance society of New York. In India, there was no development of group insurance till 1960's. Anyhow, by the end of 2002, the LIC covered nearly 70% of the individuals under group insurance. The new competitors are mostly emphasizing on group insurance for an early market penetration.

Importance of Group Insurance Scheme to both Employer and Employees

The structure of complete insurance industry has been changed with the entry of group insurance. The employers and employees are getting benefited from the various insurance products. Group insurance supports the individuals who are effected/suffering due to ill health, unemployment, disability, premature death etc at a reasonable price. The following are some of the benefits of group insurance to employers and employees.

Benefits to Employers

Group insurance has provided an important benefit to the employees and also assisted employers in improving the employees productivity and morale in the firm. The benefits provided by group insurance to the employers are as follows,

1. Firm's Size

Irrespective of the number and size of the employees, the group insurance is useful to all kinds of firms.

2. Public Image

With the assistance of group insurance schemes, the firm can improve its public image and hence attract the productive aspects of the market.

3. Retention

Inorder to retain the employees for a long period, many firms are providing group insurance as an additional benefit. Group insurance increases the productivity, morale and the retention ratio among the employees.

4. Tax Benefits

Using group insurance, the employer can avail tax deductions under taxation rules.

Benefits to Employees

The major beneficiaries of group insurance are employees group insurance has increased the scope of employee benefit to a great extent. The following are some of the benefits that are provided by group insurance to the employees,

1. Flexibility

Group insurance can be implemented in all divisions of industry and society. This makes the group insurance popular among various groups such as trade associations etc.

2. Low Cost

Group insurance policy is of low cost when compared to individual life insurance policy. This is only possible because of huge number of employees covered under same insurance policy that has decreased the cost of administration.

3. Tax Deductions

The employee can avail the benefits of tax deductions by contributing to the group insurance policy as the benefits are received in the form of group insurance policy.

4. Employee Benefit Plan

The most popular benefit plan to the employees is group insurance. A large part of working class is unable to achieve an individual insurance policy for oneself/family/spouse due to the high cost. Hence, it depends only on the employer to fund the insurance policy.

Q6. What are the features of group insurance schemes? Enlist the eligible groups for group insurance.

Answer :

Features of Group Insurance Schemes

Following are some of the features which differentiate group insurance from individual life insurance,

1. Group insurance covers risk of group members in a single contract. Homogenous group will have a representative i.e., employer, trustee, secretary or manager who will sign the contract on behalf of all the persons in the group.
2. Master policy is prepared and issued to group representative which contains names of all members of the group.
3. Premium is charged on yearly basis and policy is renewable every year.
4. The premium amount is based on age levels, working conditions, functions of people, number of people joining the group etc.
5. In group policy, there is no direct contractual relationship with individuals and there is no scope for assignment or nomination.
6. If claims are favourable, group will benefit with lower rates of premium and when claims are unfavourable group must pay higher rates of premium.
7. All persons of a group who are working actively at the time of scheme are covered without insurability and medical examination. Insurability is required for those persons who are absent for long time due to health issues.
8. Claim money is paid to the group representative but not to the individual directly. When a person exits from group, his insurance will be terminated.
9. Group insurance policies are usually issued to trustees of a trust which is formed to provide employee benefits.

Eligible Groups for Group Insurance

The eligibility norms of a well-established group are,

1. Single Employer

The most popular form of group insurance is single employers. The employer could be a partnership firm, sole proprietorship firm or any other form of organization. The employers of single employer include partners of a firm, proprietors, retained employees and the employees working in an associated subsidy/company. The employer is required to make a contract on behalf of the employees.

2. Labour Union

Sometimes, members of the union are provided with group coverage by their labour union. The policies remain with the union under such coverage. Generally, the nature of union-sponsored policies is contributory.

3. Debtor-Creditor Group

A group is formed when the banks, small finance companies, financial institutions and retailers provide the loans. This group may seek coverage under life insurance or health insurance for their debtors. The main aim behind such coverage is that the lender should not undergo financial losses because of ill health or disability or premature death of the debtor.

4. Multiple Employer Trust

There are very few employees in this type of group insurance. As they are less in number, they force the employer to enter into multiple employer trusts inorder to provide them the group benefits. The employers who are willing to participate into the group should also belong to the same type of industry. There should be an administrator and a trustee in each such trust.

5. Trade Associations

Generally, group insurance specifies the number of people (which is usually more than 10) for availing the insurance coverage. But some organizations donot have the specified number of people. In such situation, they form an association and they avail the benefit of insurance coverage to their employees. In order to ensure homogenity in the group, the participating employers should belong to the same industry/profession.

6. Self-Insurance

Sometimes, self-insurance is opted by many employers to avoid risks. However, in practice, there are very few companies that afford to deal with the claims relating to death, disability, medical expenses from their current revenues. Most of the companies find it difficult to make accurate prediction of frequency of claims and allocate the payment of benefits. If the employer thinks that the claims can be dealt from the current cash flows, it will not prefer to deal with the administrative problems involved in the claims management and other the administrative functions. Therefore, it is not recommended to have self-insurance in case of group insurance.

7. Negotiated Trusteeship

The collective bargaining takes place between the union and employers and a trusteeship is formed. The employees in such negotiated trusteeship usually come from the construction and trucking activities. To provide group insurance benefits to employees, the employers make payment to the trusteeship. A regular contribution of fund is made by the employer to the trustees in order to manage administrative costs and premium costs associated with insurance coverage.

Q7. What are the eligibility conditions in group insurance?

Answer :

Group insurance contracts are very precise in nature. These contracts take into consideration the eligibility of a person for the coverage purpose. Therefore, before participating into group insurance plan, the employees should meet certain eligibility conditions discussed as follows,

1. Full Time Employment

A worker who works the required number of hours specified by the employers as a normal work week (which has to be atleast 30 hours) is referred to as a "full-time worker". However, today some group plans are allowing part-time workers also. The eligibility requirements for part-time workers are comparatively more strict.

2. Actively-at-Work Provision

The group insurance contracts limit eligibility to an actively-at-work provision. The employee should be present at work on the effective date of coverage under the contract. If the employer is absent from the work due to injury or sickness, he/she will not be considered eligible for coverage. Coverage will start only when the employee comes back to the work. The actively-at-work provision is ignored for the employers having a large number of employers when coverage is transferred from one insurer to other insurer and the employees of the company have been insured under the contract of previous insurance company.

3. Covered Classifications

According to group insurance contracts, an employee should come under one of the classifications contained in the benefit schedule. Although, these classifications are broad enough to include all the organizational employees, they are also very restricted to exclude many organizational employees from the insurance coverage. The excluded employees may either acquire the coverage through negotiated trusteeship or through other group insurance contracts offered by the employer. At times, the excluded employees may not have coverage as the employer is willing to provide benefits only to specific group of employees. Every employee should be in only one classification. It is the policyholder who determines the suitable classification for each employee.

Apart from the above conditions, the following are the other requirements/conditions that should also be satisfied by the employee.

(i) Probationary Periods

Some groups require the new employees to satisfy a probationary period before they are eligible for coverage. The probationary period is generally of one to six months. The main aim behind the condition of probationary period is to eliminate the workers who will be with the company for a short period of time. If the workers are not willing to work permanently for the firm, then the company may have to undergo administrative expenses to maintain records of such employers and insure then. Once the probationary period ends, the employee becomes eligible for coverage.

(ii) Insurability

Although individual evidence of insurability is not required in most of the group insurance contracts, some instances underwriting practices may need the evidence of insurability. This usually happens when an employee could not avail the coverage under a contributory plan and later he wants the coverage. This situation may also arise when the employee is eligible to have a large amount of coverage. For an employee to be eligible for coverage in these cases, he/she should submit the proper evidence of insurability. If the employee fails to submit the satisfactory evidence, he/she is not eligible for coverage.

(iii) Premium Contribution

In case of a contributory group insurance plan, an employee is not eligible for coverage until and unless the proper authorization for payroll deduction is given to the policyholder. If this condition is satisfied before the employee becomes eligible, then the coverage starts on the eligibility date. Eligibility period is a period of 31 days following the eligibility date. During this period, the coverage can start if the policyholder receives the authorization of employee. Failure to provide authorization to policyholder within 31 days may require the employee to provide evidence of insurability at his/her own expense to acquire the coverage. Sometimes, an employee may drop coverage under a contributory plan and may wish to regain it afterwards. In such situation also the evidence of insurability is needed.

5.2.3 Insurance for the Underprivileged

Q8. Discuss in detail about micro-insurance.

Answer :

Introduction to Micro-Insurance

Micro-Insurance is a kind of insurance which is specifically offered to low-income individuals, households and societies with low amount of premiums and benefits that secures them from specific issues like illness, natural disasters and death. Due to the socio-economic conditions, the financially underprivileged/backward people are facing more problems when compared to other families.

Example

For making the payment of hospitalization charges, the financially backward families are positioned to sell their properties or take loans from financial institutions.

After observing this, the poverty alleviation programmes are aimed at increasing the capability of financially backward to copeup with different risks or disasters. The requirements for reducing the poverty are generating and protecting income among under privileged. Generally, the underprivileged people in rural areas requires the affordable insurance and protection from high level of risk like severe illness, crop failure, fire and accidents.

Usually, the micro-insurance operates like normal insurance but there exists some variations between micro-insurance and other insurance. The products in micro-insurance are less expensive and requires different designs and distribution strategies. Mostly, the premium of micro-insurance depends on community risk ratings but not on individual risk ratings. It can be a group insurance which covers thousands of customers under one contract. In addition to this, the micro-insurance requires a mediator between the insurance companies and customers which should be a micro-finance institution or non-government organizations (NGOs).

The micro-insurance concept was introduced in 20^{th} century for the first time in India. The micro-financial institutions have negotiated with insurers in order to purchase standardized individual or customized group insurance schemes for low income group people.

Example

A micro-insurance product has been introduced by LIC known as Jeevan Madhur under which the individuals can get a life insurance coverage of minimum ₹ 5000 and maximum ₹ 30,000. In this, the customer can pay a premium of ₹ 25 per week, ₹ 50 for 15 days, ₹ 100 per month and ₹ 250 for long periods. The policy period ranges from 5 to 15 years. By using the delivery channels like NGOs and Micro-Financial Institutions (MFIs) LIC strive to sell the government subsidized life insurance product called Janashree Bima Yojana. The people in rural areas of India are interested to save the money for future investment. Hence, the micro-insurance assists in saving the incomes of low-income individuals.

Now-a-days, micro-insurance is occupying over 5 million people which covers only percent of financially underprivileged in country.

Factors

The factors contributing to growth of micro-insurance in India are,

(a) Rising income levels among households of rural areas.

(b) Durable economic growth.

(c) Rising media publicity.

(d) Quickly developing self-help groups including more women population that results in more entrepreneurial activity in rural area.

Micro-insurance is a win-win situation where policy holders are supposed to increase their commercial profit by assisting a previously untapped market with huge capability and at the same time, underprivileged individuals or groups can have insurance for themselves at affordable premiums to secure themselves from high level of risk. While designing and marketing the micro insurance products, insurers are supposed to consider the life style and requirements of target population.

Challenges

Following are the challenges faced by insurers. They are,

(a) Reach and sustainability.

(b) High cost involved in providing coverage.

(c) Reaching people in rural areas and binterlands as there is a high transaction amount and cost of travel.

(d) Difficultly in processing claims.

For overcoming the above challenges, the insurers are supposed to design simple and flexible products that facilitates in efficient administration, where technology plays an important role.

5.3 TAX TREATMENT OF LIFE INSURANCE

Q9. Explain various types of life insurance contracts. Write a short notes on tax treatment of life insurance.

Answer : *(Model Paper-I, Q10(b) | May/June-17, Q6(a))*

Types of Insurance Contracts

For answer refer Unit-V, Page No. 5.9, Q.No. 10.

Tax Treatment of Life Insurance

Understanding the income tax treatment of life insurance is crucial for individual preparing risk management plan. The various constituents of life insurance are treated in the following manner by the income tax,

1. Premiums

The premium amount paid by individuals, towards life insurance, is not deductable for computation of taxable income. However, the premium paid on life insurance owned by a charitable organization is deductable. For example. Suppose Mr. Raj purchases a ₹ 5,00,000 life insurance policy as a fund-raiser for a charitable institute. Therefore, the premium paid by Mr. Raj is deductable from income tax amount. The death of Mr. Raj will result in payment ₹ 5,00,000 face amount to the charitable institute.

2. Death Benefits

The payment of death benefits by the insurer to the insured family, in an event of death, is not taxable when paid in a lumpsum amount. However, payment of death benefit in any other form is subjected to more complex income tax rules. The beneficiary receiving the death benefit in instalments from the insurer, can deduct only a part of the income from taxable income. Only the amount of actual death benefit included in each payment is non-taxable.

3. Cash Values

The life insurance policy terminated, before the death of the insured, and the cash benefit earned from it includes a taxable amount during the termination year. The difference in amount between the cash received, on termination, and premium paid during the year is taxable. However, no immediate tax is charged on the increase in the cash value of the policy. The increase or increment in cash value is taxed only when the policy is terminated for its cash value. Therefore, an increase in the cash value of individual's life insurance policy from ₹ 30,000 to ₹ 31,000 in one year, does not include ₹ 1,000 as taxable income.

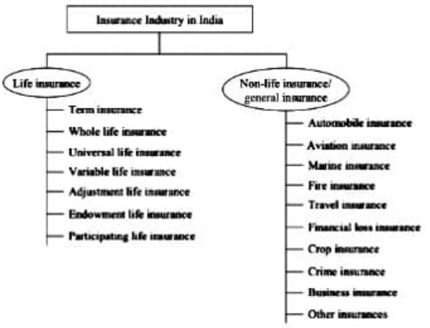
The policies, that do not meet the standard requirements and definition of life insurance by internal revenue code are taxed partially on their incremented cash values. Whereas, policies that meet these requirements and definition of insurance by internal revenue code are not taxed immediately on their incremented cash value.

The internal revenue code states that a policy is a taxable life insurance only if it passes two tests. These tests are technical and cannot be stated. Both tests ensure that the cash value of a policy is not more than its death benefit.

Q10. What are the different types of insurance contracts?

Answer :

Insurance is broadly classified into life insurance and non-life insurance.



Figure

A. Life Insurance

The insurance that pays death benefits to the beneficiaries after the death of the insured is known as life insurance.

Types of Life Insurances

The different types of life insurances are,

1. Term Insurance

Term insurance is the insurance that provides temporary protection to the insured for a limited term period.

2. Whole Life Insurance

The whole life insurance is one of the permanent type of insurance and is effective till the insured complete life time.

3. Universal Life Insurance

Universal life contracts have most variable premium payment options. The policy owners have the authority to decide the time and amount of subsequent premiums.

4. Variable Life Insurance

The variable life insurance is a whole-life insurance. In this insurance an insured will have the exclusive right to decide on where to invest the policy's cash value.

5. **Adjustment Life Insurance**

The policy can be adjusted according to the changing protection needs and the premium payment ability of the policy holder.

The nature of the policy is known by the relationship between the initial face amount and the premium. The coverage amount is selected by the insured at the beginning. The insured also has the option to select the amount of premium to be paid within a limited time period. Therefore, the adjustable life insurance either provides life time protection or limited protection depending upon the choice of an insured person. The premium amount and the face amount can be adjusted at monthly or annually.

6. **Endowment Life Insurance**

The endowment life insurance is a policy in which the insurer promises to pay the face amount upon death of the insured and even on the survival of the insured at the end of the policy term.

7. **Participating Life Insurance**

The life insurance policy under which dividends are paid out to the policy holder annually are known as participating life insurance.

(B) Non-life Insurance

Non-life insurance refers to insurance of products excluding the life insurance. It might be insurance of property, motor vehicles, accident and so on. The companies which offers the non-life insurance must pay for losses or damages caused to the insured property.

Types of Non-life Insurance or General Insurance

The following types of insurances comes under non-life insurance/general insurance category,

1. **Automobile Insurance**

It covers loss due to legal liability against the driver and losses to the automobile.

2. **Aviation Insurance**

It covers hull, spares, war and liability risks.

3. **Business Insurance**

Business insurance includes professional liability insurance and business owner's policy that covers multiple risks of business owners.

4. **Builder's Risk Insurance**

It covers risk of losses, damages to property during construction.

5. **Credit Insurance**

It covers risk of being unpaid because of borrower's disability. If the debtor dies or is disabled, the insurer clears the debt in full or part.

Example

Mortgage insurance.

6. **Casualty Insurance**

It covers accidents which are not restricted to one specific property.

7. **Crime Insurance**

It covers losses which arises because of criminal acts of third party.

Example

Company can attain this type of insurance against thefts and robbery.

8. **Crop Insurance**

It covers farmer's risks involved in growing crops. It insures loss or damage of crops caused due to weather, hail, drought, insects/diseases etc.

9. **Equipment Breakdown Insurance**

It is also called as boiler insurance and covers accidental losses to machinery and equipment.

10. **Expatriate Insurance**

It covers losses of both individuals and organizations operating in foreign country for their automobiles, property, liability and business presents.

11. **Environmental Liability Insurance**

It gives coverage against physical injury or damage to property caused due to escape of pollutants or dispersal.

12. **Professional Liability Insurance/Professional in Demrity Insurance**

It insures professionals like doctors, lawyers, accountants and others against claims arising out of negligence.

13. **Locked Fund Insurance**

It is a hybrid insurance which provide protection against tampering of public funds. It is jointly issued by Bank and Government. This insurance is applicable only for funds which require maximum security.

14. **Marine Insurance**

It is a common type of insurance that protects goods shipped. It covers losses of ships and cargos. Marine insurance may be on inland waterways or main oceans.

15. **Travel Insurance**

It insurers travellers against medical expenses, travel delay, personal liabilities etc.

16. **Financial Loss Insurance**

It covers individuals as well as organizations for financial losses arising due to various perils like fire, credit payment etc.

17. **Fire Insurance**

Fire insurance can be defined as "The agreement which covers the loss incurred by incurred because of fire accident by the insurer according to a specified insurance policy.

5.4 CLAIMS SETTLEMENT

Q11. What do you mean by claim? Explain different types of life insurance claims.

Answer :

Claim

Claim refers to the demand made by an insured or beneficiary to the insurer to make payment of insurance policy benefits.

Types of Life Insurance Claims

The insurance claims are divided into three types,

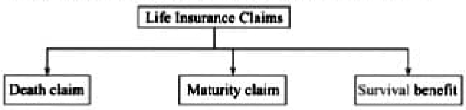


Figure: Types of Insurance Claims

The basic necessity for settlement of claim arises on death of the policy holder or maturity of policy.

1. Death Claim

The death claim arises on the death of the policy holder. Death can be natural, accidental or a suicide. Death claim is further classified as,

(i) Premature Claim

In case of premature claim, insured person dies within three (3) years from the date on which insurance policy is taken.

(ii) Other Claim

In case of other claim, insured person dies after three (3) years from the date on which insurance policy is taken.

2. Maturity Claim

The essential features of maturity claims are listed below,

(i) A maturity claim is payable according to the conditions of the contract on the completion of the policy term period, if the insured person is alive till the maturity date.

(ii) This claim includes the assured sum, vested bonuses and other specified money. Any debt or charge under the policy such as outstanding premia and loans will be deducted from the assured sum.

(iii) When it comes to proof of title, settlement of maturity claims is quite easy as the policy money is paid directly to the insured person itself.

(iv) The insurance company will make payment to the absolute assignee in case of an absolute assigned policy.

(v) Policy holders are informed in advance about the maturity date by the insurers. The insurers also send the discharge form to the policy holders and request them to return the discharge form signed, duly stamped and enclosed with the documents such as,

- The policy document
- Age proof (if age is not admitted yet)
- In case if an assignment is made the the stamped document of assignment should also be submitted.

3. Survival Benefit Payment

Some policies such as money back policies allow the insured person for the survival benefit before the full term policy expires. Settlement of the survival benefit is less complicated when compared to settlement of maturity claim.

The procedure for settlement of survival benefit is as follows,

(i) Insurer intimates the policy holder in advance about the money back policies and sends a discharge voucher.

(ii) The policy holder returns the documents duly stamped and signed and witnessed with the original policy document for necessary approval.

(iii) The gross amount is nothing but the installments of the sum of money assured payable.

(iv) After subtracting the outstanding premium, outstanding loan, interest etc., from the gross amount, the net amount will arrive.

Q12. What is claim settlement? Discuss in detail procedure for claim settlement for life insurance policies.

Answer :

Claim Settlement

Claim settlement means paying back the money by the insurance company to the insurance policy holder. A claim is said to be settled when the policy holder duly receives the money which is due to him by the company according to the terms and conditions of policy. The process of claim settlement directly reflects the efficiency and effectiveness of the company. A company which correctly and successfully settles down the claims of clients achieves trustworthiness and loyalty. While the insurance companies which involve litigations in claim settlements owe bad reputation in the market.

Claim settlement of an insurance policy usually takes place in two circumstances,

1. On death of policy holder.
2. On maturity of insurance policy.

Procedure for Settlement of Claim on the Death of Policy Holder

In case of death of policy holder, the following procedure is followed and the claim is settled down,

Figure: Procedure for Settlement of Claim on Death of Policy Holder

1. **Intimation of Death**

The process of claim settlement basically starts with intimating about the death of policy holder (insured) to the respective office of LIC from where the policy was being purchased. The intimation letter should include the following details, full name of the insured, policy number, date and place of death and so on. The letter must be forwarded by the correct nominee, assignee or the close relative of policy holder. The relationship between the person sending the intimation letter and the insured should also be mentioned.

2. **Filling Forms of Claim**

Soon after receiving the intimation letter, the official authorities would send certain claim forms to the nominee. These forms need to be duly filled up in a prescribed format and should be returned back to the authorities within the specified time period.

3. **Submitting Proof of Age and Death**

In addition to sending letter of death intimation and filled up forms, it is also required to submit the proof of age and death to the concerned officials. For submitting the proof of age, school certificate, birth certificate or citizenship card might be used. And for proof of death, death certificate from hospital or from municipality might be submitted. If necessary, it is also required to submit the statement of doctor who was giving treatment to the insured and the certificate from hospital in which the insured got treatment for the illness.

4. **Ownership Certificate**

Certificate of ownership is needed incase when there is no valid nominee or assignee mentioned in the policy. It can be a succession certificate, letters of probate and the similar kind.

5. **Payment of Money**

After successfully completing all the steps, the money is paid to the right person i.e., nominee. The LIC company sends a cheque in the name of nominee which can be withdrawn anytime. A form of discharge is also sent by the company in order to acknowledge the receipt of the policy amount.

Procedure for Settlement of Claim on the Maturity of Insurance Policy

The settlement of maturity claim follows a simple procedure. The procedure gets started soon after the completion of maturity period of a life insurance policy. Prior to the claim settlement, discharge form is sent by the divisional head of the LIC to the policy holder before two months of maturity date. After receiving the filled in discharge form, claim settlement takes place. The procedure of maturity claim settlement include, three main steps as follows,

Step-1: Intimation of the Maturity

The first step in the claim settlement is intimation about the maturity to the policy. The divisional officer of the LIC is responsible for intimating the insured about the maturity before two months of maturity date. The insured is asked to fill the discharge form which is sent along with the intimation and submits the required documents. The documents include the original document of policy, age proof of the insured and the assignment or reassignment deed of the policy. In case, where the intimation is not received, the policy holder should approach the concerned branch enquiring about the copy of intimation.

Step-2: Submission of Required Documents

Soon after receiving the intimation letter from the company, the policy holder must forward the following documents to the given address,

(i) **Filled up Discharge Form**

Discharge form is issued by the divisional head along with intimation letter. The insured has to duly fill up and sign this letter and forward the same to LIC's branch.

(ii) **Original Document of Policy**

Every policy holder is given an original document of the life insurance policy. In case if this document is lost then an indemnity bond with reliable surety needs to be sent.

(iii) Receipts of Premium Paid

The receipts which acknowledge the payment of premium regularly must be submitted.

(iv) Proof of Age

Proof of age is also required in settlement of maturity claim. If it is not submitted, then it must be sent along with the discharge form. Proof of age can be either a Birth Certificate of insured, High school certificate or any other document given by the authorized body.

(v) Other Documents

Any other document demanded by the corporation should be submitted.

Step-3: Payment of Money

After successfully receiving the required documents from policy holder, the corporation would send an account payee cheque to the insured. The amount of money would be \according to the terms and conditions of policy selected. The procedure of claim settlement would come to an end after duly paying the claim amount to the insured.

Q13. What do you mean by managing claims and losses? Write the features of claim management.

Answer :

Managing Claims and Losses

Insurer should indemnify the losses that the members of a group have incurred. Settlement of losses or claims do not mean only payment of money to insured but also involve a complex process more than the payment. The insurance company should maintain a claim department which is involved in settlement of losses. Claim representatives of an insurance company may be either salaried employees or contractors.

In case of property and liability insurance companies, the employees/claim representatives are called adjusters. The insurer should be very careful while taking decisions related to the differentiation between the fair and unfair claims and settlements.

Features of Claim Management

Some of the important characteristic features of insurance chaims are as follows,

1. There has been an increase in awareness regarding insurance after the liberalization of insurance sector. Almost all businesses and individuals are involved in one or the other type of insurance. This has increased the number of claim transactions to be processed.

2. Brokers and other intermediaries are handling most of the transactions. This results in increased necessity of record maintenance, information update, data analysis and the difficulties in settlement of claims.

3. The complexity in insurance process has increased, thus leading to increase in the number of steps and people (legal experts, loss adjuster, witness etc).

4. More than 3-4 insurance companies are involved in some insurance products. This results in the complexity in claim settlement and the method of risk distribution.

5. Increased number of transactions are being carried out because of increased fraudulent, exaggerated and repeated claims.

6. Due to the excessive reinsurance transactions, there is more complexity in a claim.

5.5 DISTRIBUTION CHANNEL – MARKETING INTERMEDIARIES

Q14. What is distribution channel? Explain the role and responsibilities of agents and brokers in insurance.

Answer : *Model Paper-II, Q10(a)*

Distribution Channel

There are many intermediaries between the insurer and the buyer who are developing awareness about insurance and attracting large section of people towards insurance. Distribution is an essential element for insurance penetration so IRDA has developed a variety of intermediaries to operate according to regulations and guidelines. They include agents, brokers etc. These marketing intermediaries who are helping the insurers to occupy various market segments is known as distribution channel.

Role of Agents and Brokers in Insurance Contracts

An agent is a legal representative of insurer/insurance company. Agent is given special authority to manage the things that happen beyond the limits or scope of his/her functions. Agents are mostly meant for marketing the insurance policies but not for channelization of the policies.

Broker is a legal representative of insured person, who acts as an intermediary between the insured and insurer. Like agents, brokers have a business relationship with the number of insurers. They do not enter into any legal agreement with any insurer i.e., brokers are not bond by the terms of any insurance legally without any agreement between them. Broker can assure the insured about the coverage amount only after receiving acceptance from the insurer to take the risk of loss.

Authority of Agents and Brokers

In general, policy holders or investors provide the authority to the agents as per the rules and norms of charter, bylaws and insurer. The sources of authority for both agents and brokers are agent agreement and ratification.

(i) Agent agreement specifies the duties, roles, responsibilities, rights and obligations that should be performed by both insurer and the agent involved in the agreement.

(ii) Ratification is the legal authority given to the agent to perform the things that are beyond the scope of the agent and accepted by the insurer afterwards.

Waiver and Estoppel are the two important principles of law of agency. Waiver is the loss of a right willingly and is based on the consent of the agent. Whereas, Estoppel is the loss of rights without any intention to do so and is an imposed liability. These liabilities come into force with the activation of an insurance policy.

Example

If an agent having complete knowledge about the terms of policy issued it beyond the scope of the terms without acceptance of insurer, then the loss incurred due to the damage cannot be claimed by the insurer. The court will consider it as an Estoppel and gives judgement in favour of insurer.

Responsibilities of Insurance Agents and Brokers

Insurance agents and brokers of various insurance policies are engaged in marketing the insurance products to new customers.

(i) Agents are field representatives and represent the insurance company. Some agents acts as underwriters.

(ii) Agents are required to estimate the risks associated with each policy.

(iii) Brokers are representatives of insured and offer best possible priced insurance to insured person by offering number of insurance options.

(iv) Agents and brokers are required to gather information regarding customer preferences and needs.

(v) They should be involved in underwriting new policies.

(vi) They should guide the customers in processing the claims for losses.

(vii) They should resolve the problems related to customer claims.

(viii) They should provide follow-up services to clients about the changes in policies.

(ix) They need to review the financial position of the client periodically.

(x) They should develop an appropriate plan to compensate the losses of the customers/insured persons.

(xi) Brokers are required to quote the coverage amount, issue policies on behalf of insurer and also collect premiums from insured.

(xii) Sometimes agents will be provided with an authority to collect premium.

Q15. Explain about different types of insurance agents and brokers.

Answer :

Types of Agents

Agents are classified into three types. They are,

1. General agents
2. Independent agents
3. Direct writer/captive agents.

1. General Agents

General agents act as an independent contractor who also represents a single insurer. The general agent should recruit, train, empower and control the new agents under his guidance. Insurer is required to pay a fixed percentage of commission to a general agent on the basis of sales performance of the new agents. Mostly, insurer bear the expenses of hiring and training the new agents and other office and administrative expenses.

2. Independent Agents

Independent agents is also called as American agency system, in which the independent agents represent number of insurers. Some of the features of this system include,

- These agents are legally authorized agents to perform business/to sell insurance products on behalf of the insurers. Insurers will pay the agents, the commission based on the productivity of the agent.
- Independent agency has the right to renew the policies with other insurers after termination of contracts with one insurer.
- The commission paid to the independent agent differ with the type of the insurance. Independent agents also receive a second commission called profit sharing commission or contingent commission to compensate the losses incurred for agents.

The major function of independent agent is selling/ marketing the insurance products. The other functions include,

- Managing losses and claims
- Providing loss control services to customers/insured persons
- Billing/Collecting the premiums from insured on behalf of insurer persons.

In general, insurer prefer direct billing.

Example

Auto insurance, home owner insurance etc.

3. Captive Agents or Direct Writer

Direct writer is an insurer of the insurance company who act as a sales person. Direct writer will be paid salary + social security taxes + selling expenses. Like exclusive agents, direct writer also represents one insurer.

Types of Brokers

Brokers are classified into four categories by IRDA. They are,

(a) Direct insurance brokers

(b) Reinsurance brokers

(c) Composite brokers

(d) Insurance consultants.

(a) Direct Insurance Brokers

These are again categorized into two groups,

(i) Direct general insurance brokers

(ii) Direct life insurance brokers.

(i) Direct General Insurance Brokers

The brokers who are registered with the general insurance business are called direct general insurance brokers. They represent the insured persons to offer general insurance policies.

(ii) Direct Life Insurance Brokers

The brokers who were registered with life insurance businesses are called direct life insurance brokers.

Direct brokers should have a minimum capital amount of 50 lakhs to act as a broker. They will receive a commission on sales which is minimum 50 lakhs/year.

(b) Reinsurance Brokers

The brokers who are associated with reinsurance activities are called reinsurance brokers. Reinsurance brokers require a minimum capital amount of 200 lakhs. They will receive minimum remuneration limit of ₹ 2.5 crores.

(c) Composite Brokers

Brokers who are associated with both insurance and reinsurance activities are called composite brokers. Composite brokers should possess a minimum capital amount of ₹ 250 lakhs and the minimum remuneration limit is ₹ 5 crores.

(d) Insurance Consultants

IRDA should approve insurance consultants. Insurance consultants act as intermediaries between insured and insurer to educate the public regarding the significance of insurer and encourage them to purchase insurance policies.

5.6 GENERAL INSURANCE – TYPES

Q16. What is general insurance? Explain the risk faced by owner of asset.

Answer :

General Insurance

General insurance is a contingent contract with the aim of providing security against the risk. It is a short-term contract, premium of which varies with the renewal of contract. In this type of insurance, actual loss can be measured and insured is paid with amount equal to the extent of loss occurred. The risk of loss will increase as time passes. There is no specification made relating to surrender value or paid up value. It maintains reserve for unexpired risk.

Risk Faced By Owner of Assets

The owner of asset may face the risk that asset may get damaged, destroyed or being stolen by different causes is known as property risk. A property may face three types of losses. They are direct losses, indirect loss and losses from extra expenses for maintaining property. Property may also face losses due to natural disasters like flood, earthquake, storm, fire etc.

(i) Direct Loss

Direct loss emerge directly from unsecured peril. For example: If a house is insured against fire and eventually house destroyed by fire then damage caused to property is direct loss.

(ii) Indirect Loss

Indirect loss is also known as consequential loss. It is caused as a result of some previous loss. Loss incurred earlier directly leads to indirect loss. For Example: Factory which insured fire damage by fire policy will incur some other damages to physical property like building, machinery, etc due to fire.

(iii) Extra Expenses

When company incur loss due to fire then alternative arrangement should be made to continue the work. Temporary premises must be taken on rent till reconstruction of damaged building. Even machine must be taken on rent or lease to continue the production to maintain satisfied customers and market share.

Q17. Explain different types of general insurance policies.

Answer : *(Model Paper-II, Q10(b) | April/May-15, Q6(b))*

Non Life Insurance

Non-life insurance refers to insurance of products excluding the life insurance. It might be insurance of property, motor vehicles, accident and so on. The companies which offers the non-life insurance must pay for losses or damages caused to the insured property.

Types of Non-life Insurance or General Insurance

The following types of insurances comes under non-life insurance/general insurance category,

1. **Automobile Insurance**

   It covers loss due to legal liability against the driver and losses to the automobile.

2. **Aviation Insurance**

   It covers hull, spares, war and liability risks.

3. **Business Insurance**

   Business insurance includes professional liability insurance and business owner's policy that covers multiple risks of business owners.

4. **Builder's Risk Insurance**

   It covers risk of losses, damages to property during construction.

5. **Credit Insurance**

   It covers risk of being unpaid because of borrower's disability. If the debtor dies or is disabled, the insurer clears the debt in full or part.

   Example: Mortgage insurance.

6. **Casualty Insurance**

   It covers accidents which are not restricted to one specific property.

7. **Crime Insurance**

   It covers losses which arises because of criminal acts of third party.

   Example: Company can attain this type of insurance against thefts and robbery.

8. **Crop Insurance**

   It covers farmer's risks involved in growing crops. It insures loss or damage of crops caused due to weather, hail, drought, insects/diseases etc.

9. **Equipment Breakdown Insurance**

   It is also called as boiler insurance and covers accidental losses to machinery and equipment.

10. **Expatriate Insurance**

    It covers losses of both individuals and organizations operating in foreign country for their automobiles, property, liability and business presents.

11. **Environmental Liability Insurance**

    It gives coverage against physical injury or damage to property caused due to escape of pollutants or dispersal.

12. **Professional Liability Insurance/Professional In Demrity Insurance**

    It insures professionals like doctors, lawyers, accountants and others against claims arising out of negligence.

13. **Locked Fund Insurance**

    It is a hybrid insurance which provide protection against tampering of public funds. It is jointly issued by Bank and Government. This insurance is applicable only for funds which require maximum security.

14. **Marine Insurance**

    It is a common type of insurance that protects goods shipped. It covers losses of ships and cargos. Marine insurance may be on inland waterways or main oceans.

15. **Travel Insurance**

    It insurers travellers against medical expenses, travel delay, personal liabilities etc.

16. **Financial Loss Insurance**

    It covers individuals as well as organizations for financial losses arising due to various perils like fire, credit payment etc.

17. **Fire Insurance**

    Fire insurance can be defined as "The agreement which covers the loss incurred by incurred because of fire accident by the insurer according to a specified insurance policy.

Q18. Explain the differences between life insurance and general insurance.

Answer : *May/June-13, Q6(a)*

Following are some of the differences existing between life insurance and general insurance.

	Basis of Difference	Life Insurance	General Insurance
1.	Natural of contract	Life insurance is not a contingent contract.	General insurance is a contingent contract.
2.	Object	The object of life insurance policy is to provide protection and encourage the investment of savings.	The object of general insurance policy is to provide security against the risk.
3.	Period and Premium	Life insurance is a long-term contract and its premium remains fixed throughout the contract.	General insurance is a short-term contract whose premium varies with the renewal of contract.
4.	Indermity	Under life insurance policy actual loss occurred on the death of a person is not possible to measure. Because of this, an insured amount of policy is payable.	Under general insurance policy, actual loss is measured and insured amount is paid to the extent of loss occurred.
5.	Risk	In life insurance policy, risk associated with the life of the individual increases with the growing age of a person.	In general insurance policy, risk of loss increases even though with the passage of time.
6.	Amount of claim	In life insurance policy, full amount of policy is paid either at the event of maturity or death which ever is earlier.	In general insurance policy, amount of policy is paid either to the extent of loss suffered by an individual or the sum assured by a party which ever is low.
7.	Surrender value	It contains a specified amount of surrender value or paid up value.	It is not associated with surrender value or paid-up value.
8.	Reserve for unexpired risk.	It does not maintain any reserve for unexpired risk.	It maintains reserve for unexpired risk.

5.6.1 Health and Accident Insurance

Q19. What is health insurance? Explain its importance and various health insurance policies in India.

Answer :

Health Insurance

The term 'Health insurance' is a generic term which covers different types of insurance contracts which are even though interrelated with each other but offers security against different types of risk. Health insurance was also referred as accident insurance, accident and health insurance, accident and sickness insurance and disability insurance. Health insurance is basically divided into two different types of insurance as follows,

1. Disability income insurance
2. Medical expense insurance.

Importance of Health Insurance

Health insurance has became one of the essential need of the Indian people because of the following reasons,

- Most of the employed Indians are found to be suffering from health issues due to lack of maintenance of balanced diet. Thus as a result number of health issues are increasing.
- The trend of consuming junk food is rapidly growing in urban areas and metropolitan cities. Thus, ill health is common is such areas.
- The percentage has increased drastically in serious diseases among Indians in the last few decades. According to a study about 30 % of Indians suffer from heart attacks within the age of 40 - 45 years.
- Majority of diseases are found to be due to cardio-vascular disorders.
- Diabetes has became a common disease among the Indian families.
- Treatment of disease is highly expensive. Thus health insurance helps in providing financial support to individuals.

- Reaching a good hospital or medical centres has become difficult in India. Thus increase the unnecessary costs to patients.
- Many Indians earn low income and suffers from improper financial planning. They do not have enough savings to cure their family members

Thus, by analyzing above points, health insurance can be treated as an essential requirement of every individual.

Various Health Insurance Policies

Following are the various health insurance policies,

	Types	Description
1.	Individual Mediclaim Policy	This policy was introduced in the year 1986 for the benefit of people belonging to 5 - 80 years. According to this policy, the medical expenses paid by the patient would be reimbursed by the company. The age of individual is considered for deciding the premium to be paid.
2.	Overseas Mediclaim Policy	Overseas mediclaim policy is designed for those people who intends to visit other nations for their personal or professional purpose. With this policy the individuals can claim for expenses which they have incurred for medical illness during travelling. Overseas mediclaim policy expires at the end of journey or at the completion of a specified time period, which ever is earlier. The age limit for this policy ranges from 6 months to 90 years and the maximum time period of policy would be 180 days.
3.	Videsh Yatra Mitra Policy	Videsh yatra mitra policy is similar to overseas mediclaim policy, but offers wide range of benefits. It covers expenses not only relating to medical illness, but also indemnify for loss of passport, checked baggage, accidents and so on. It was introduced in year 1998 by General Insurance Corporation.
4.	Bhavishya Arogya Policy	This policy aims to benefit individuals after their retirement. The insured has to select the policy during his/her service and will be benefited after the age of 55 years or retirement.
5.	Jan Arogya Bima Policy	Jan Arogya Bima policy is designed for the weaker and poorer sections of India. The age limit is 5-70 years and the children below 5 years will be covered on behalf of their parents. It mainly compensate for illnesses such as food poisiong, pneumonia, Jaundice and so on.
6.	Cancer Insurance Policy	This policy is specific for cancer patients. The members are required to pay premium for the policy. In case, any member is diagnosed with cancer, he/she will be compensated for the complete treatment expenses.
7.	Raj Rajeshwari Mahila Kalyan Yojana	This policy benefits women aged between 10 to 75 years. The insured will be provided with financial assistance in the event of disablement or death. It also have provisions in case of death of husbands.

Q20. Write about the following,

(a) Personal Accident Insurance.

(b) Group Personal Accident Policy.

Answer :

(a) Personal Accident Insurance

Personal accident insurance aims at paying a fixed amount of compensation to person who met with an accident leading to death or disablement in body due to accidental injury. During policy period, if policy holder gets injured solely and directly from accident then insurer pay then policy amount to insured or to his legal nominee in case of death, permanent disablement, partial disablement etc. Claim amount of policy will be paid only once in case of death. Some policies make payment for education of dependent children.

When insured becomes partial disable then insurer will pay one time or periodically till recovery. There are some conditions under which insurer will not pay any compensation such as death, injury or disablement caused to insured because of self-injury, suicide or attempt to suicide etc.

Insured need to follow policy conditions like written notice must be given before cremation in case of death and in any case, notice must be given within one month after the death. A written notice must be submitted as a proof of claims, if insured lost his sight or damage his limbs. Even insured person will be examined by doctor of insurance company. Claim amount will not be paid if it involves any fraudulent statement.

Any changes in business or occupation and relating to health of insured must be informed to insurance company by giving a written notice immediately.

(b) Group Personal Accident Policy

Group personal accident policy will be issued only if there is common relationship among group members and a common point of controlling insurance schemes.

The coverage of this policy is same as individual policy excluding the education grant and cumulative bonus. On payment of additional premium, medical expenses can be reimbursed. By making extensions to policy even risk involved in war can be covered. The sum insured will be different for each insured person. Based on risks, premium amount is charged from each person.

Claim form is made to acquire information relating to the following,

- Personal information relating to age, occupation etc.
- All details relating to accident, type of injuries etc.
- Name and address of the doctor who treated the insured.
- Medical certificate of the respective doctor.
- Details of other insurances to appeal for contribution clause and verify whether it is specified in proposal form.
- Along with claim form insurer must submit medical certificate, medical examiner's report and death certificate.

5.6.2 Motor and Fire Insurance

Q21. What is motor vehicle insurance? Explain different types of motor vehicle insurance policies.

Answer :

Motor Vehicle Insurance

Motor vehicle insurance was emerged in United Kingdom, but later on it has gained importance in the whole world. This type of insurance cover risk of owner and vehicle along with the financial liability which may develop from accident causing harm to third party. When there is no insurance all the expenses relating to repair of vehicle, treatment of injured must be borne by the person. Hence, motor vehicle insurance is essential. In India, motor vehicle insurance is made compulsory after the amendment of Act for motorists to insure against the risk of liability to third parties.

Some of the important provisions relating to Motor Vehicle Act are as follows,

1. It is necessary to have insurance against risks of third party.
2. Motor vehicles which are carrying hazardous goods must take insurance policy under Public Liability Act, 1991, also.
3. Driving of uninsured vehicle results in violation of provisions of Sec.- 146 leading to punishment of imprisonment or fine or both.

Types of Motor Vehicle Insurance Policies

Following are the different types of policies which are issued under motor vehicles insurance to cover the losses emerging from motor vehicles,

(i) Act/Liability Policy

Act/Liability policy is issued with the aim to fulfill the requirements of Motor Vehicles Act, 1988 and cover act risks. According to Act, it is compulsory for motor vehicles to have insurance to overcome the liabilities emerging from use of motor vehicles in a public place. All the vehicles which are driving within the territorial limits of India must have an act policy at all times. In India, motor insurance business is governed by All India Motor Tariff. The violation of provision is punishable with fine, etc as per Motor Vehicles Act. There are two types of policy forms for all types of vehicles i.e., form A and form B. Form A or Act policy covers act liability which is an essential requirement of Motor Vehicles Act. A person cannot use vehicle without this minimum insurance cover.

(ii) Third Party Policy

Third party policy provide insurance coverage for liabilities of third parties who suffer the loss resulting in damage of property/personal injury/death. Beside this, policy also includes fire, theft risks and legal liability of persons who are related to motor vehicles. Without insurance no person can use or allow any other person to use vehicle in public place. Policy must have coverage of liabilities faced by insured or damage caused to property of third party or physical injury to any passenger of public service vehicle.

(iii) Package/Comprehensive Policy

This policy is also referred as form 'B' policy. It is an optional policy which covers personal damage, losses and act liability. Insurance companies issued package policy for comprehensive risks wherein coverage of policy differs with various classes of vehicles. Even, the rate of premium vary with classes of vehicles.

(iv) Garage Insurance Policy

Garage insurance policy cover the risks which is related to motor vehicles standing in motor garages or service stations.

(v) Collision Insurance Policy

Collision insurance policy provide insurance cover to damages and losses which are caused by collision or accident that takes place between two or more vehicles.

Q22. What is fire insurance policy? Explain its scope and types.

Answer :

Fire Insurance Policy

Fire insurance can be defined as "The agreement which covers the loss incurred by insured because of fire accident according to a specified insurance policy."The loss caused to the policy holder due to fire accidents would be compensated to insured after conducting appropriate examinations and enquiries. Fire insurance helps an individual a shopkeeper or a business firm to rebuild its lost property or to restart its operations as usual which were halted due to unexpected accident and provides enough financial support to the insured parties. Lack of fire insurance would lead to unexpected results to the society and industry. Hence, risk involved in fire and allied perils are covered under fire insurance.

Features of Fire Insurance

The following are the features of fire insurance policy,

1. Policy

Fire insurance involves a specific policy, on which both the parties agree to enter into a contract. The policy duly states the procedure of premium payments and claim settlement. It also discloses the amount of loss which would be paid by the insurance on occurrence of fire.

2. Lawful Consideration

A fire insurance policy includes lawful consideration from the insured. The insured must duly pay the stated premium within the time period.

3. Material Facts

In a fire insurance policy, it is necessary to disclose all the material facts by both the parties i.e insurance company and the policy holder. Fire insurance policy works on the principle of utmost good faith.

Scope of Fire Insurance

The scope of fire insurance basically depends upon the nature of the policy selected. General fire insurance policy have limited scope to the insured, while the special policies have a wider scope for the policy holders. The main requirements for a fire insurance policy for raising claim is as follows,

1. The cause of incident should be actual fire or ignition.
2. The fire must be accidental or incidental but not intentional.
3. The property or goods showed damaged because of incident.

General Policy

An active general fire insurance policy covers the following losses,

- Goods or property being damaged due to fire
- Goods or property spoiled while restricting the expansion of fire.
- Damage to goods while shifting from area of fire.
- Payment of wages to people who are involved in the process of extinguishing fire.

Special Policies

Now-a-days insurance companies are offering special fire insurance policies in order to cover the losses of insured upto a maximum extent, policy covers the following losses,

- All losses covered in general fire insurance policy.
- Losses due to stoppage in production.
- Compensation for minimisation of profits etc.

Types of Fire Insurance Policies

Fire insurance are of nine types as follows,

	Type	Description
1.	Specific Policy	In this policy, a specific amount is decided for compensating the losses. The actual value of goods or property is not considered. The insured would be receiving only the amount which is specified in the agreement in case of fire.
2.	Floating Policy	For some businesses, the goods are not stored at one place. They might be stored at different locations as per the convenience. With the help of floating policy, a person can get insurance of his goods located at different places. He need not to take separate fire insurance policy for separate locations. A floating policy covers all the goods, located at different locations of the insured.
3.	Declaration Policy	Declaration policies are framed on those goods which cause fluctuations in their value and volume frequently. The time period of the policy would be for one year, but the insured has to declare the value of goods at risk monthly.
4.	Average Policy	Under average policy, the insurer would pay the proportionate amount of the actual loss caused due to fire. It aims to prevent under insurance. Suppose under an average policy the goods of ₹ 50,000 are insured for ₹ 30,000 and the loss due to fire is 28,000. Then the compensation amount would be $\frac{30,000}{50,000} \times 28,000 = 16,800$.
5.	Valued Policy	There are certain goods which are difficult to be valued. Examples : Pictures, scripts, arts, etc. For such type of goods, the valued policy is issued. The value of the goods would be mentioned in the agreement, and in case of fire, the insurer is liable to pay the specified value.
6.	Adjustable Policy	An adjustable policy is one in which the amount of premium is adjusted periodically. The adjustment takes place due to the changes in the value of stock. As soon as there is a change in stock value, the insurer should be informed and they would change the values in accordance to the value of stock.
7.	Comprehensive Policy	Comprehensive policies are those which provides special benefits to insured in addition to the ordinary benefits. The special benefits include, Compensation for loss due to stoppage in business operations, loss due to burglary, civil commotion, riots and so on.
8.	Consequential Loss Policy	Under this policy, the insurer would also pays fixed expenses such as salaries, rent etc to the insured in addition to the loss due to fire. It cover all the expenses that take place due to dislocation of firm because of fire incident.
9.	Replacement Policy	Under replacement policy the insurer takes up the responsibility of replacing the property which damaged due to fire. Property such as building, plant, furniture etc would be replaced instead of paying compensation to the loss due to fire.

5.6.3 Credit and Crop Insurance

Q23. What is credit insurance? Explain the three corporations established by government of India to provide credit insurance.

Answer : *Model Paper-III, Q10(a)*

Credit Insurance

Credit insurance covers the risk of being unpaid because of borrower's disability. If the debtor dies or is disabled, the insurer clears the debt in full or part. Example: Mortgage insurance. In India, insurance companies both old and new have not proposed credit insurance. So, the government of India has taken measures to build guarantee corporations to secure lender against default risk of the borrower with respect to special groups like exporters, small scale industries etc.

Corporations of Credit Insurance

Following three corporations were established by government of India to provide credit insurance,

1. **Deposit Insurance and Credit Guarantee Corporation of India**

   For answer refer Unit-V, Page No. 5.23, Q.No. 25.

2. **Export Credit Guarantee Corporation of India**

   For answer refer Unit-V, Page No. 5.22, Q.No. 24.

3. **Credit Guarantee Fund Trust for Small Industries**

   For answer refer Unit-V, Page No. 5.23, Q.No. 26.

Although, these organizations are similar to insurance companies but does not come under the control of IRDA nor they are managed by the Insurance Act 1938. Later on export credit guarantee corporation comes under IRDA regulations.

Q24. Discuss in detail about Export Credit Guarantee Corporation of India Ltd. (ECGC).

Answer :

In 1957, Government of India established Export Credit Guarantee Corporation of India ltd (ECGC) in order to provide assistance and reinforce export promotion. The operations of ECGC are under the regulations of IRDA and are controlled by a board of directors indicating banks, insurance companies, trade, industry, government etc.

ECGC strive to develop a favorable environment wherein exporters can acquire flexible and timely credit facilities from banks. It is mainly established to secure exporters from results of default risk and to facilitate them to broaden their business abroad without any fear of loss. Credit risk insurance offer protection to exporter and its banker on default of importer or its bank abroad. The coverage of ECGC can be classified into following groups. They are standard policy, specific policies, financial guarantee and special schemes.

Standard Policy

Both commercial and political risks are covered under standard policy from the date of shipment but credit term must not be more than 180 days. Commercial risk relating to policy comprises of default of the buyer, insolvency of buyer and failure of importer to accept the goods. Political risks includes government restrictions due to war, civil war, import restrictions revolution or cancellation of import licence. There are some issues which are not covered the policy are exchange rates fluctuations, quality disputes, commercial disputes, failure of buyer to acquire exchange authorization and failure of exporters to fulfil the contract.

Specific Policies

Specific policies comprises of specific shipments policy for both comprehensive risks and political risks, specific contract policy for both comprehensive risks and political risks. Shipments policy provide coverage only for post shipment whereas contract policy provides coverage for pre shipment stage and loss relating to unshipped goods.

Financial Guarantees

The main aim of guarantees is to cover the loss of bank due to default of exporter in discharging his liabilities. ECGC would bare a large portion of banks loss and to satisfy the varying requirements of exporters, following types of guarantees were introduced by the corporation,

(i) Packing Credit Guarantee

Under packing credit guarantee, any loan provided to an exporter for manufacturing, processing, purchasing or packing of goods for the purpose of export are covered. Duration of this guarantee is for a period of twelve months and approval of corporation is required if period of repaying advance exceed 360 days from date of advance. Incase of loss, bank can claim $66\frac{2}{3}$ percent of loss from corporation and to provide cover for packing credit advances for customers, corporation offers Whole-Turnover Packing Credit Guarantee (WTPCG).

(ii) Export Production Finance Guarantee

This guarantee offers advances to banks at pre-shipment stage for full amount of cost of production. The coverage and rate of premium are same as that of packing credit guarantee. Banks are eligible for concessionary premium rate and higher percentage of coverage, if banks have WTPCG.

(iii) Post-Shipment Export Credit Guarantee

Under this guarantee, all post-shipment finance provided to exporter through banks in the form of purchase, negotiation or discount of export bills or advance against bills collection are covered.

(iv) Transfer Guarantee

When confirmation is given by any Indian bank to a foreign letter of credit then it is obliged to honour the drafts withdrawn by beneficiary of letter of credit. In case of default of foreign bank in reimbursing the amount paid to the exporter then confirming bank has to bare the loss. Transfer guarantee is issued depending on option of bank to cover only political risks or only commercial risks or both. Loss relating to political risks is covered upto 90 percent and commercial risks is covered upto 75 percent. Corporation issue some other policies like export finance guarantee, export performance guarantee, export finance guarantee for overseas projects etc.

Q25. Explain about Deposit Insurance and Credit Guarantee Corporation of India Ltd (DICGC).

Answer :

After the failure of banks in 1950s and early 1960s, deposit insurance scheme was initiated on 1st January 1962. A credit guarantee scheme was also promoted, developed and managed by credit guarantee organization (RBI) for small scale industries. In 1978, the deposit insurance corporation ltd took responsibility of all the credit guarantee functions. The credit guarantee corporation of India ltd was approved as an agency which offers a wide range of guarantees for loans provided to small and needy borrowers by credit institutions.

Under guarantee scheme, all credit facilities are covered which are offered by banks to farmers, agriculturists, transport operators, retail traders, professionals and self employed persons.

Deposit Insurance

DICGC provide insurance coverage to all commercial banks which consists of foreign banks branches, local area banks, regional rural banks and cooperative banks. It also insure deposits excluding deposits of government and banks. Bank insures each depositor with maximum limit of ₹ 1,00,000 (including principal and interest) in one or more accounts at the time of liquidation or on date of amalgation/merger.

DICGC consider deposits in different branches of same bank as same and provide insurance upto limit of one lakh. If deposits are made in different banks with different ownership then they are considered as separate. if deposits are made in more than one bank then separate deposit insurance limit is fixed for each bank deposit. Banks can set-off their due amount from deposit and provide deposit insurance after netting of dues. Insured bank has to bare the premium of deposit insurance.

Incase of bank's failure and liquidation, insured money is paid to the liquidator by DICGC so that payment can be made to depositors. At the time of merger/amalgation of banks, amount due by failed bank to depositors is paid to transfer bank. Deposit insurance scheme is made mandatory and no bank can refuse it. Corporation has a right to cancel the insured banks's registration if bank does not pay premium for three continuous periods.

Q26. Discuss in detail about Credit Guarantee Fund Trust for Small Industries (CGFTSI).

Answer :

Both government of India and SIDBI developed a trust and named it as credit guarantee fund trust for small industries. The main objective of the trust was to offer guarantee in the form of insurance against any default in repaying credit amount provided to small scale borrowers without any security or guarantees. Banks were motivated to lend money on merit basis of the scheme and not to generate problems by asking additional securities from entrepreneur.

Eligible Lenders

The eligible lenders for guarantee cover are all scheduled commercial banks, National Small Industries Corporation Ltd (NSIC) and North Eastern Development Finance Corporation Ltd (NEDFI). Even offices of foreign banks situated in India are also eligible.

Conditions

Following are some of the conditions to be followed in CGFTSI,

1. For approving guarantee cover, trust will depend on appraisal made by lenders and will not have any re-appraisal.
2. Personal guarantee of the promoters can be acquired but guarantee from third party will not be accepted.
3. Some concessions are provided to artisans, women and some other group while offering credit facilities.
4. Loans for transport operators are not applicable for guarantee cover.
5. The credit facility offered for rehabilitation/nursing of sick units will be covered under guarantee scheme but as per the terms decided by the trust.
6. Borrower must take advantage of all credit facilities from one financial institution.

7. Credit facilitates will not be covered under guarantee scheme, if it is partly with security and partly without security.
8. Credit facility which is more than ₹ 25 lakhs must have collateral security/third party guarantee in addition.

Fee Structure

The trust will charge 2.5 percent of loan amount as one time fee and then annual fee of 1 percent is charged. The service charge payable to CGTSI for offering credit facility to artisans will be paid by office of development commissioner (Handicrafts). Even the one time guarantee fee is reduced from 2.50 percent to 1.50 percent for loans granted,

(i) Upto the amount of ₹ 2 lakhs
(ii) To female entrepreneurs
(iii) Eligible borrowers staying in Jammu and Kashmir and North Eastern region.

Defaulted Loans and Claim

Outstanding principal and interest amount in borrower's account and the outstanding amount in working capital facilities is referred as amount in default. The accumulated unpaid interest will be included in amount in default when it becomes non-performing asset with respect to term loan at the time of preferring any claim.

Q27. What is trade credit insurance? Discuss its scope and restrictions.

Answer :

Trade Credit Insurance

Trade credit insurance refers to insurance provided to supplier against following risks,

(i) Default of goods or services by the buyers who are from same country (domestic risk) or from another country (export risk).
(ii) Default as a consequence of insolvency of buyer.
(iii) Default after specified months after due date (protracted default).
(iv) Default after an event which is beyond the control of the buyer or the seller (political risk).

Trade credit insurance transaction refers to transaction that exist between seller and buyer of commodities and services. A contract which takesplace between insurer and seller who are directly linked with an underlying trade transaction, which is carried out for delivering goods or services is termed as trade credit insurance policy. Credit cover exist only when there is authentic fulfilment of trade transaction and satisfaction of the contract terms.

Scope and Conditions

1. Policy holder should pay the premium amount for complete policy period.
2. Every policy holder has a buyer as customer who shall make the payment to policy holder for purchasing of goods and services as per the policy document filed with the insurer.
3. Trade receivable of policy holder cannot be generated from factoring or reserve factoring or any other similar activity.
4. Policy holder acts as a supplier of goods or services in return for a fair market value.
5. Credit risk which is insured need to have a direct connection with trade transaction.

Restrictions and Limitations of Insurance

Following are the restrictions and limitations of trade credit insurance,

1. Insurer must not issue a trade credit insurance policy to banks/financiers/lenders.
2. There should be a subrogation condition in every trade credit insurance policy and no waiver is allowed in any situation.
3. The credit risk of buyer must be evaluated by the insurer only if buyer's contribution in total turnover of the policy holder is more than 2%.
4. The trade policy must clearly specify credit limits of all buyers and also an overall limit under the policy.
5. Before offering cover to any services, insurer must do evaluation of those services by taking into accounts its methodology and valuation in the past.
6. Any receivable gained from a consultancy service or financial service must not be covered under trade credit insurance policy.

7. On the basis of whole turnover, policy is sold to seller which covers all buyers. Insurer may exclude some buyers from policy of specific regions depending on credit risk.
8. A trade credit insurance policy covers only pre-agreed buyers and upto agreed limit. Prior approval of the insurer is required to implement any changes in the limits.

Hence, insurer must appoint a credit management agency to look into the matters relating to buyer after getting approval from board of directors. In order to have insurance cover, policyholder must record statement of credit policy, credit management and procedures for controlling the implementation of the credit policy to the insurer as a part of proposal.

Q28. Discuss in detail about crop insurance.

Answer : *Model Paper-III, Q10(b)*

Crop Insurance

Under crop insurance, insurance companies enters into a contract with the farmers to provide them remedy in case of loss or damage to crops by natural calamities. Crop Insurance is familiar in countries where agriculture plays a key role in economy.

Objectives

Some of the objectives of crop insurance are as follows,

(i) The national agricultural insurance scheme aims at giving insurance coverage along with financial support to the farmers who lost their crops due to natural calamities, pests and diseases.

(ii) It also facilitates the farmers to implement advanced technology and progressive farming methods.

(iii) It also stabilizes the incomes earned from farm during unfavourable years.

Crops Covered

The crops which are covered in the policy are food crops, oilseeds, cotton, sugarcane and potato, annual commercial crops depending on availability of past yield data and also number of crop cutting experiments to estimate the yield are also covered. Before year ending, crops to be covered under policy must be specified.

Areas to be Covered

The scheme is offered in all states of the Indian Union. The States which are selecting the scheme must specify the crops to be covered under the scheme for particular year. However, after selecting the scheme state must continue it for atleast three years.

Farmers to be Covered

Farmers including share croppers and tenant farmers whoever growing the specified crops in the specified places comes under the coverage of this scheme and it also covers the farmers who are growing specified crops by availing and not availing the loans from financial institutions.

Risks Covered and Exclusions

The scheme provide risk insurance for yield losses caused because of non-preventable risks such as natural fire and lightning, storms, cyclones, typhoons, floods etc. Whereas loss incurred because of war end nuclear risk, malacious damage and preventable risks are not covered under the scheme as they are considered as exclusion.

Important Conditions Applicable for Coverage of Risk

Following are some of the important conditions which are applicable for coverage of risk,

(i) Eventhough the loans have been provided, the scheme does not cover the crops which are not planted.

(ii) If the crops are sown and resulted in failure then indemnity claims can be raised under the scheme.

(iii) The scheme does not cover further loaning of the sown crops which gets damaged due to unfavourable seasonal conditions, pest or diseases and even where there is no chance of reviving crops.

(iv) The scheme covers specified crops only till their harvesting stage. The losses occurred to the crop after cutting or harvesting are not included in the scheme.

(v) Personal accident cover is also offered to farmers along with crop insurance on a nominal premium of ₹ 15 in which government give ₹ 10. The insurance also includes bodily injury and death to a maximum extent of ₹ 50,000.

(vi) The scheme also covers the risk relating to pending sales of agricultural produce storage after harvest.

SHORT QUESTIONS AND ANSWERS

Q1. Write a note on whole life insurance and endowment life insurance.

OR

Endowment Life Insurance *(May/June-12, Q1(i) | May/June-13, Q1(g))*

(Refer Only Topic: Endowment Life Insurance)

OR

Whole Life Insurance

(Refer Only Topic: Whole Life Insurance)

Answer : *(Model Paper-II, Q4 | April/May-15, Q1(i))*

Endowment Life Insurance

The endowment life insurance is a policy in which the insurer promises to pay the face amount upon the death of the insured and even on the survival of the insured at the end of the policy term. The policy term may be for 10 years or 20 years.

Whole Life Insurance

The whole life insurance is one of the permanent type of insurance and is effective till the insured's complete life time. Eventhough the total face value of the life insurance coverage is less than the term insurance, it contributes about half of the total life insurance policies sold in the United States.

Q2. Write a note on Non Life Insurance and General Insurance.

OR

Non-Life Insurance *(Model Paper-III, Q1 | April/May-14, Q1(i))*

OR

General Insurance

Answer : *May/June-13, Q1(i)*

Non-Life Insurance

Non-life insurance refers to insurance of products excluding the life insurance. It might be insurance of property, motor vehicles, accident and so on. The companies which offers the non-life insurance must pay for losses or damages caused to the insured property.

General Insurance

General insurance is a contingent contract with the aim of providing security against the risk. It is a short-term contract, premium of which varies with the renewal of contract. In this type of insurance, actual loss can be measured and insured is paid with amount equal to the extent of loss occurred. The risk of loss will increase as time passes. There is no specification made relating to surrender value or paid up value. It maintains reserve for unexpired risk.

Q3. Remuneration to Insurance Broker

Answer : *(Model Paper-I, Q5 | May/June-16, Q1(h))*

Insurance agents receive salaries based on the sales performance. Some insurers appoint employees as sales person for which they will pay salary for regular activities and sales commission for marketing the products. Three ways of payment are available for agents,

(i) Salary for employed agents

(ii) Salary + Commission

(iii) Salary + Bonus.

Brokers will be paid on commission basis based on the type and amount of coverage of insurance. Both agents and brokers receive bonus and incentives for accomplishing the sales objective of the insurance company.

Q4. What is claim settlement?

Answer :

Claim settlement means paying back the money by the insurance company to the insurance policy holder. A claim is said to be settled when the policy holder duly receives the money which is due to him by the company according to the terms and conditions of policy. The process of claim settlement directly reflects the efficiency and effectiveness of the company. A company which correctly and successfully settles down the claims of clients achieves trustworthiness and loyalty. While the insurance companies which involve litigations in claim settlements owe bad reputation in the market.

Claim settlement of an insurance policy usually takes place in two circumstances,

1. On death of policy holder.
2. On maturity of insurance policy.

Q5. What do you mean by group insurance?

Answer :

In group insurance, many persons belonging to a group like members of an association or employees in an organization are covered under one contract. The insurer and the group policy owner enter into a contract called 'master contract' for the benefit of the members of the group.

Group insurance operates at a great level and provide its benefits to a group of persons at a moderate cost. Group insurance has grown in recent years due to advancement of economy and consequential development of the organized sector. It acts as an instrument to implement the social security measures of the government. Group insurance has now became an essential part of life insurance business.

Q6. What is motor vehicle insurance?

Answer :

Motor vehicle insurance was emerged in United Kingdom, but later on it has gained importance in the whole world. This type of insurance cover risk of owner and vehicle along with the financial liability which may develop from accident causing harm to third party. When there is no insurance all the expenses relating to repair of vehicle, treatment of injured must be borne by the person. Hence, motor vehicle insurance is essential. In India, motor vehicle insurance is made compulsory after the amendment of Act for motorists to insure against the risk of liability to third parties.

Some of the important provisions relating to Motor Vehicle Act are as follows,

1. It is necessary to have insurance against risks of third party.
2. Motor vehicles which are carrying hazardous goods must take insurance policy under Public Liability Act, 1991, also.
3. Driving of uninsured vehicle results in violation of provisions of Sec.- 146 leading to punishment of imprisonment or fine or both.

INTERNAL ASSESSMENT

I. Multiple Choice

1. One among this is not the types of general insurance? [ ]
   (a) Marine Insurance (b) Travel insurance
   (c) Fire Insurance (d) Universal life insurance
2. The different premium payment methods are ________. [ ]
   (a) Straight life contract (b) Limited pay life policy
   (c) Single premium life policy (d) All the above
3. ________ is one of the types of life insurance. [ ]
   (a) Variable life insurance (b) Crop insurance
   (c) Business insurance (d) Automobile insurance
4. ________ covers losses arising because of criminal acts of third party. [ ]
   (a) Aviation insurance (b) Business insurance
   (c) Crime insurance (d) Casualty insurance
5. ________ is a type of insurance for low income individuals and households. [ ]
   (a) Micro insurance (b) Macro insurance
   (c) Life insurance (d) None
6. Distribution channel of insurance includes ________. [ ]
   (a) Agents (b) Brokers
   (c) Both (a) and (b) (d) Insurer
7. ________ are issued to protect various groups mainly the employers in business firms, partnership firms and professionals. [ ]
   (a) Annuities (b) Group insurance policy
   (c) Pension policy (d) None
8. Different types of motor vehicle insurance policies are ________. [ ]
   (a) Act policy (b) Collision insurance policy
   (c) Garage insurance policy (d) All the above
9. Health insurance is basically divided into two types, disability income insurance and ________. [ ]
   (a) Participating life insurance (b) Medical expense insurance
   (c) Adjustment life insurance (d) None
10. ________ offers periodic payments, when insured is unable to do work due to sickness or injury. [ ]
   (a) Medical expense insurance (b) Ordinary life insurance
   (c) Disability income insurance (d) Adjustment life insurance

II. Fill in the Blanks

1. __________ is a life insurance plan offered to an employer to compensate the financial loss on the life of a key member of the organizaton.
2. The insurance plan which provides temporary protection to the insured for a limited term period is __________.
3. __________ is a common type of insurance that protects goods which are shipped.
4. Farmer's risk involved in growing crops is covered under __________.
5. In case of __________ claim, insured person dies within three years from the date on which insurance policy is taken.
6. __________ means paying bank the money by the insurance company to the insurance policy holder.
7. __________ refers to a type of income which an employee receive on his/her retirement from the employer.
8. Money back policy is an endowment policy which is issued as a __________.
9. __________ is an insurance policy taken by the parents on the lives of their children.
10. __________ can assure the insured about the coverage amount only after receiving acceptance from the insurer to take the risk of loss.

KEY

I. Multiple Choice

1. (d)
2. (d)
3. (a)
4. (c)
5. (a)
6. (c)
7. (b)
8. (d)
9. (b)
10. (c)

II. Fill in the Blanks

1. Keyman insurance
2. Term plan
3. Marine insurance
4. Crop insurance
5. Premature
6. Claim settlement
7. Pension
8. With profit policy
9. Child insurance plans
10. Broker.

III. Very Short Questions and Answers

Q1. What do you mean by life insurance?

Answer :

The insurance that pays death benefits to the beneficiaries after the death of the insured is known as life insurance.

Q2. What is credit Insurance?

Answer :

Covers risk of being unpaid because of borrower's disability. If the debtor dies or is disabled, the insurer clears the debt in full or part. Ex: Mortgage insurance.

Q3. What do you understand by the term 'Health-Insurance?

Answer :

The term 'Health insurance' is a generic term which covers different types of insurance contracts which are even though interrelated with each other but offers security against different types of risk.

Q4. What is Medical Expense Insurance?

Answer :

Medical expense insurance is a form of health insurance pays the costs of medical case that takes place or arises out of the sickness or injury.

Q5. What do you mean by Marine Insurance?

Answer :

A common type of insurance that protects goods shipped. It covers losses of ships and cargos. Marine insurance may be on inland waterways or main oceans.